S. HRG. 99-311

TECHNICAL CORRECTIONS ACT OF 1985

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 814

JUNE 5, 1985

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TECHNICAL CORRECTIONS ACT OF 1985

WEDNESDAY, JUNE 5, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Symms, Grassley, Long, Bentsen, Moynihan, Baucus, and Boren.

[The press release announcing the hearing follows:]

[Press Release No. 85-029]

HEARING ON TECHNICAL CORRECTIONS SCHEDULED FOR JUNE 5

The Senate Committee on Finance will conduct a hearing on S. 814, the Technical Corrections Act of 1985 and also receive testimony on technical corrections to the Retirement Equity Act of 1984, Senator Bob Packwood (R-Oregon), Chairman of the Committee, announced today.

The hearing will begin at 9:30 a.m., Wednesday, June 5, 1985, in Room SD-215 of the Dirksen Senate Office Building.

The hearing will focus on a review of S. 814, the Technical Corrections Act of 1985, as introduced by Senator Packwood and Senator Russell Long (D-Louisiana) earlier this year. S. 814 makes technical corrections relating to the Tax Reform Act of 1984.

"This bill represents considerable work on a most difficult range of tax issues," Senator Packwood said of S. 814. "I am hopeful we move forward expenditiously to conclude our involvement with the Tax Reform Act of 1984, which cleared the Congress a year ago.

"Likewise," he added, "it is my aim that we receive comment on technical corrections to the REtirement Equity Act," Senator Packwood said.

The **CHAIRMAN**. The hearing will come to order. Today's hearing concerns S. 814, the Technical Corrections Act of 1985, introduced earlier this year by Senators Long and myself. The bill makes a number of technical, clerical, and conforming amendments to the tax legislation enacted in 1984, including the Deficit Reduction Act of 1984. The bill also makes certain technical amendments to provisions in the 1984 act relating to Social Security and trade. Because of the length and complexity of the 1984 legislation, it was to be expected that numerous technical errors would have to be corrected in subsequent remedial legislation. The various congressional staffs, with valuable assistance from the Treasury Department and outside professional groups and individuals, have tried to identify those areas where the original congressional intent in enacting the legislation has not been properly carried out. The staffs were directed, however, and I want to emphasize this, to include only amendments of a purely technical nature, and that continues to be my goal. This piece of legislation is not the appropriate place to revisit substantive decisions made last year. I look forward to the various testimonies today, and we will examine closely all of the submissions to ensure that we have neither overlooked any technical amendments to the 1984 legislation or included any amendments that should not have been made. We have a great many witnesses scheduled to testify today. And in order to accommodate them all. I would request that each witness limit his presentation to 3 minutes. Their entire submissions will be a part of the record. That 3-minute limitation, of course, does not apply to the Treasury Department because they have got to testify on everything that we have before us, and we have today Hon. Roger Mentz, who is the Deputy Assistant Secretary for Tax Policy as our first witness. Mr. Secretary, we are glad to have you with us. Let me ask if the Senators have any opening statements. Senator Symms.

Senator SYMMS. No, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Secretary, go right ahead.

STATEMENT OF THE HON. ROGER MENTZ, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary MENTZ. Good morning, Mr. Chairman, Mr. Symms, Mr. Baucus. It is a pleasure to be here this morning and an honor to testify before the Senate Finance Committee in my new role as Deputy Assistant Secretary. On the Technical Corrections Act, Mr. Chairman, the Treasury Department supports virtually all of the provisions contained in that act. As you mentioned, we have worked with the staffs on developing the act. It is only the very few provisions that we have some question or problem about that I would like to discuss this morning. I will take them in the order in which they are presented in the act. With your permission, I would like to make my written statement a part of the record, and I will just hit the very highlights of the testimony.

The CHAIRMAN. I will say again to you and to all of the witnesses: The entire statement will be in the record, and to the extent that I had them yesterday, I have had a chance to read the statements last night. That is one of the reasons why we going to very strictly insist upon our rules of advanced submission of the statements so that the Senators can have a chance to read them before the hearings. Go right ahead, Mr. Secretary.

Secretary MENTZ. Thank you. The first subject I would like to discuss briefly is the dividend-received deduction. This involves a technical correction to the 1984 act, but the roots of the technical problem go all the way back to 1958. Let me try to explain very briefly what the problem is. The dividend-received deduction allows a corporation a deduction for 85 percent of the dividends received from another corporation. The purpose of that is to avoid double taxation. The earnings would normally be taxed by the payor corporation and the dividends received deduction of 85 percent is designed to avoid double taxation. In certain cases, it is 100 percent where it is a parent-subsidiary relationship, but normally it is 85 percent.

The dividends received deduction applies where the stock is held by the recipient corporation for a period of more than 45 days. It was previously 15 days, but was changed to 45 days in the Tax Reform Act. There is a limitation on that 45-day holding period rule. The limitation is that if the recipient corporation has a "put," that is, an option to sell the stock, or has a contract to sell the stock, or has made a short sale of the stock, the holding period does not run so that the 45 days does not run. And under the statute, the dividends received deduction is not allowed. Now, there has been an ambiguity in current law, going all the way back to 1958, as to what happens where a corporate taxpayer holds stock and also has a put. He may hold the put for 20 days or 20 years, but he doesn't exercise the put and continues to hold the stock. The question is: Is the dividends received deduction disallowed during the entire period that the "put" is held? The answer to that question is somewhat unclear under current law although it is our understanding that it has not been administered to disallow the deductions. It is certainly a possible construction that all the dividends received during that period would be disallowed.

The change in the 1984 act expanded the limitations and the holding period but basically did not change this provision for this tolling of the holding period while there is an option to sell. And the Technical Corrections Act would address this issue frontally by saying it doesn't matter whether the stock is disposed of or not. If the stock is held and there is an outstanding "put," no dividends received deduction would be allowed for as long as that put is in existence. In other words, if there is a "put" and the "put" is for 20 years—an unrealistic example, but we will take the extreme case—no dividends received deduction would be allowed for the full 20-year period.

Mr. Chairman, it is the Treasury Department's view that that is a little too onerous, that it goes beyond the purpose of the limitation on the dividends received deduction, which is to limit a kind of a tax arbitrage where you buy the stock, get the dividend essentially tax-free, then sell the stock, and take a deductible capital loss. And the suggestion we would have would be that we could work with the congressional staffs to devise another form of rule that would reduce basis of the stock where you have an outstanding "put," and thus would in effect disallow the loss and thereby avoid the tax arbitrage with respect to the first dividend, but not get into the situation where it would disallow dividends for a very long period of time. The reason that this is a problem—and particularly a problem now—is that many regulated investment companies hedge the down-side risk of investments in perfectly proper fashion by buying "puts" and if the dividend received deduction were disallowed with respect to all those type transactions, we think that is probably not a fair result.

So, as I say, we would like to work with the staff to see if we can't craft a better rule than this kind of a total shotgun approach of disallowing all the dividends received deductions. Mr. Chairman, I would propose just to go right through the couple of other points I have unless someone would like to interrupt with a question. Whatever your procedure is, I will be glad to follow it.

The CHAIRMAN. I would just as soon have you go all the way through. I know you have a certain question about multiple trusts, and you have one other addition you want to make, and I would rather have you finish your statement. Then we can ask our questions.

Secretary MENTZ. All right. On the multiple trust rule, the Tax Reform Act had a provision that, with respect to any trusts that were set up substantially by the same grantor with substantially the same beneficiaries, and where a principal purpose is tax avoidance, that those trusts could be combined into one trust. And the abuse here is using a variety of trusts to take advantage of the lower rates and going up the rate structure, you can set up 50 trusts for the same beneficiary and thereby avoid having income tax at the higher rate.

The rule as enacted—the statute as enacted in the Tax Reform Act—was effective for years beginning after March 1, 1984. There is a proposal in the Technical Corrections Act that would, in effect, grandfather all then-existing trusts and only apply the new rule to trusts set up after March 1, 1984, or to new corpus additions to the trust made after March 1, 1984. The Treasury's view is that this provision would gut the 1984 rule because it would exempt an enormous number of trusts that were set up with a tax avoidance purpose before 1984. Now, we recognize that because of a change in the 1984 act that combines the husband and wife as one grantor, there may be certain situations where there are sympathetic conditions for relief and I would like there again, with the staffs, to see if we couldn't craft a more targeted approach, rather than go with the Technical Corrections proposal which would basically just grandfather all of those trusts, even though tax avoidance was a principal purpose in their creation.

I would like to skip over some of the more technical of these technical corrections. I am splitting hairs here.

Senator CHAFEE. I had a feeling we were in a technical area when I saw no line in the hall and empty seats here.

Secretary MENTZ. When I see your eyes glazing over, I will try to move along. There is a provision in the Technical Corrections Act dealing with the interest exclusion for ESOP loans. I know of one particular Senator who has a great interest in this, and I don't see him present, but nevertheless I think it only fair that the Treasury make this point. In the Tax Reform Act, there is a provision that exempts one-half of the interest received by banks on certain qualified loans to ESOP's—Employee Stock Ownership Plans. That income is treated effectively as tax-exempt income, completely exempt from tax. Now, under the provisions of the Internal Revenue Code, enacted I believe in 1982, when a bank holds tax-exempt securities—and of course, banks have interest expense—there is a provision that simply disallows 20 percent of the interest expense attributable to the holding of the tax-exempt obligations. The theory of this provision is that, under current law banks are exempt from the general rule that disallows deductions for interest expense on obligations incurred or continued to purchase or carry tax exempt securities. Thus, if you or I hold tax exempts and have interest expense, we would have our interest expense disallowed under a statute that doesn't apply to banks. The 1982 provision is sort of a surrogate for that provision, and disallows 20 percent of the interest paid by a bank where it is holding tax-exempt securities. The question which, really, I don't believe was addressed in the 1984 act is: How does this provision apply to ESOP loans by banks, the interest on which is partially tax exempt? I frankly cannot distinguish between tax-exempt interest from a loan to an ESOP and tax-exempt interest from an ordinary tax-exempt bond. I imagine probably the senior Senator from Louisiana could make the distinction, but I would simply say this: I am not sure that an investment in the general obligation bond of the State of Louisiana should be treated any differently than an investment that a bank might make in an ESOP of some Yankee corporation. So, the Treasury's bottom line on this is that the Treasury opposes the provision that would make a separate exception and not have the 20-percent disallowance apply to loans by banks to ESOP's.

There are a couple of points that I would just like to mention that are not in the Technical Corrections Act. We are suggesting them as sort of additional new starters. One of them deals with employer operated eating facilities, and this is in our old favorite, the fringe benefit area. There is a provision in the Technical Corrections Act that basically says that an employee cafeteria does not result in taxable income to employees if the revenue derived from the facility normally equals or exceeds the direct operating cost. It is a *de minimis* fringe benefit that is not going to cause a tax problem. The difficulty with that provision is many, if not most, employers' cafeteria are subsidized. That is, what the employees pay normally will be less than the price that it costs the employer to provide the meals. Either they are provided from an outside food service or provided inside. If you read the law literally, that means that the fair market value of the food—not just the difference in cost, but the fair market value of the food—somehow has to be taxed to the employees. It really is a nightmare. To do it correctly, you would have to figure out what employees had what to eat—how many hotdogs did he eat, how many cups of coffee?—and what the difference is between what he paid and what the fair market value of that food is. It is a bedevilling problem that Treasury would like to see resolved in a simpler way, and what we are suggesting is: In the case of a cafeteria that is subsidized, exempt the employees. Don't provide any tax on the employees, but as a surrogate for that, provide a form of excise tax on the employer. And the excise tax could be developed so that it would roughly equal the amount of tax that the IRS would have collected from the employees had the subsidy been included in their income and taxed to them. This would require some assumptions about what the rates might be. In fact, the rate might be higher—it should be higher—in the case where the cafeteria is discriminatory, that is, where it is available on a preferential basis to higher-paid employees. And the reason for the higher rate would be that normally those people would be in higher brackets. But in any case, the suggestion is: Let's cut through a very complicated problem by not imputing income to employees, and let's do it in a much more simple way by an excise tax directly on the employer. Various problems might come up in terms of employers which are tax exempt, but we think we can deal with them; if it is a section 501(c)(3) or a State, we think you can still apply the excise tax. If it is the Federal Government, really all it is is a budget item in that case, but in any case, you would have a parity of treatment for employees, that is, employees would be tax exempt on a subsidized employer-provided cafeteria whether they work for Uncle Sam or XYZ company.

One last point I would like to mention, and that is the subject of the repeal of the 30-percent withholding tax on interest paid to foreign persons. As you no doubt remember, this was a late starter in the 1984 act. Some changes were made involving the computation of the foreign tax credit limitation, and it was discovered somewhat late in the game that these would have the effect of making it impossible for most U.S. companies to borrow in the Eurodollar market by the use of Netherlands-Antilles finance subsidiaries. The United States has basically been, for the last 20 years, pretty well committed to encouraging or at least facilitating U.S. corporations to borrow in the Eurodollar market. The Eurodollar market is an enormous capital market, and it has been a national policy to facilitate U.S. borrowers being able to tap that market. It has been done in various ways. In the early 1970's, there was an exemption—direct exemption—from withholding tax, and the exemption only applied to public issues. I would suggest to you this morning that is really where the United States ought to be in its unilateral exemption from withholding tax. The unilateral exemption ought to apply only to public issues. If you read the 1984 act and the legislative history, it would certainly be possible to conclude that it applies to not just public issues but private placements as well, or indeed, even trade payables. It is possible to conclude that if a U.S. company buys some machinery or equipment from a Japanese manufacturer and pays for it with a note that bears interest, that there is no U.S. withholding on that note because of the 1984 act. Whether our proposal to limit the 30 percent withholding repeal to public offerings is or is not a technical correction is perhaps a matter of debate, but I would suggest to you that it could be regarded as a technical correction. If not, I want to state what our position is anyway so that we find another vehicle and get to this result.

The reason that you absolutely must have an exemption for a public offering is it is impossible to sell Eurobond obligations in the public market without a direct exemption. That is because you have a public market out there where these obligations are traded, and it is not possible to rely on any one treaty since they are traded among people of various countries, some of whom have treaty protection and others do not. And the practice very firmly embedded in that market requires the obligation to be free of withholding. All Eurodollar offerings that I have ever seen—and I have seen a lot of them—require the covenant of the borrower to make up any withholding tax. If you don't have an exemption for public offerings, your public offerings in the Eurodollar market are just absolutely shut down, and that is, I think, not an acceptable U.S. policy, and certainly Congress has found it unacceptable for 20 years.

It is different for the case of private placements. U.S. companies, large or small, if they want to borrow directly from a financial institution can do so through a treaty exemption—the United Kingdom, Federal Republic of Germany, Netherlands, for instance—and the treaty rate is zero there, and they can go ahead and place their paper privately and have the benefit of a zero rate of withholding. Now, the lender would probably prefer a unilateral exemption, because the lender could then sell off that paper to someone else—an Arab perhaps or someone else who doesn't have treaty protection. That makes the paper a little bit more valuable, but the basic point is that even without a withholding exemption—a unilateral exemption—the U.S. borrower can still borrow in the private placement market, as opposed to the public market, where he absolutely cannot. It is our judgment that for treaty negotiation purposes, it is important for the Treasury not to give that one away unilaterally. Most other jurisdictions do not have a unilateral exemption for all withholding of interest in the Eurodollar-type borrowing, and it is effectively a chit that can be used—and we do use—in treaty negotiations. We totally agree with the purpose of the 1984 act in exempting public offerings, but we think a narrowing of that provision, Mr. Chairman, would be appropriate. Whether or not it is appropriate in the Technical Corrections Act, I think I would have to leave that to your judgment. Your collective judgment.

Mr. Chairman, that is all the remarks that I have on my testimony. I would be happy to answer any questions.

The CHAIRMAN. Mr. Secretary, thank you.

[The prepared written statement of Assistant Secretary Mentz follows:]

For Release Upon Delivery
Expected at 9:30 a.m. E.D.T.
June 5, 1985

STATEMENT OF
J. ROGER MENTZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

It is my pleasure to present the views of the Treasury Department on S. 814, the Technical Corrections Act of 1985.

The Tax Reform Act of 1984 had an extremely broad scope, touching virtually every area of U.S. tax law, including time value of money tax accounting, corporate and partnership taxation, and the taxation of employee benefits, tax-exempt bonds, life insurance and life insurance companies, private foundations, and international business. The Tax Reform Act also included significant changes directed at simplification of the Code, as well as provisions as diverse as those involving luxury cars and the excise tax on sport fishing equipment.

Considering the scope and complexity of the Tax Reform Act, legislation implementing technical corrections seemed inevitable. Nevertheless, only a relatively modest number of technical corrections are included in the bill as introduced -- this is a compliment to the skills of the persons involved in the preparation and passage of the Tax Reform Act.

The Treasury Department supports virtually all of the proposed amendments included in S. 814. We will discuss in the order in which they appear in the bill those few provisions that we oppose or that we believe require modification or, at least, amplification. In addition, we will discuss several areas included in the Tax Reform Act that are not the subject of any provision in the bill, but which we believe require technical correction.

TECHNICAL CORRECTIONS ACT OF 1985

Dividends Received Deduction

Section 104(b)(1) of the bill would amend the holding period requirements applicable to stock owned by corporations claiming the dividends received deduction. Under current law, the dividends received deduction is provided to corporate owners */ of stock in order to limit the imposition of multiple taxation as dividends are paid by one corporation to another corporation. Corporate income generally is subject first to the corporate income tax and then to a shareholder level tax when the corporate earnings are distributed as dividends to noncorporate shareholders. The dividends received deduction provides the mechanism to ensure that significant additional corporate level tax is not imposed on intermediate distributions of earnings to corporate shareholders.

Under current law, however, the dividends received deduction is not allowed with respect to any dividend on any share of stock which is sold or otherwise disposed of in any case in which the taxpayer has not held such share for a specified time period, or to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in related property. These limitations were originally enacted in 1958 to deny a dividends received deduction in certain cases in which so-called tax arbitrage opportunities exist.

Generally, the price of a share of stock drops immediately after the stock becomes "ex-dividend," because the holder of the stock on the ex-dividend date, rather than the transferee, is entitled to receive the dividend. Absent a holding period requirement, a corporate taxpayer could acquire shares immediately prior to the date shares become ex-dividend and, following the ex-dividend date when the value of the shares has dropped by an amount approximately equal to the anticipated

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*/ The corporate dividends received deduction is provided only to the corporation that, under general principles of tax law, is determined to bear the benefits and burdens of ownership of corporate stock. For example, the dividends received deduction would not be available to the purported owner of stock purchased in a transaction that in form conveys ownership of the stock together with a right to "put" the stock to the seller, but in substance is a loan of the "purchase amount" secured by the transferred stock, irrespective of the issue discussed in this testimony.

dividend, the corporation could sell the shares at a loss. In such case, often called "dividend stripping," the corporate shareholder could claim the dividends received deduction with respect to the dividend, thereby making the dividend income almost tax-exempt, and could utilize the short-term capital loss resulting from the sale of the shares to offset against capital gain income.

As origi[illegible] enacted, the required holding period was 16 days (91 days[illegible]the case of certain preferred dividends). The market risks associated with holding the shares for those periods were viewed as adequate to deter taxpayers from engaging in the tax-motivated transaction described above. The 16-day and 91-day holding periods, however, did not include periods during which the taxpayer reduced or eliminated the risk of loss on the underlying stock by entering into a short sale of, acquiring an option to sell, or entering into a binding contract to sell, substantially identical stock or securities. Such transactions could be utilized to "lock in" the sales price of stock and allow a corporate taxpayer to engage in dividend stripping with respect to a dividend payment, regardless of the period the stock is held.

For example, if stock is purchased immediately before the ex-dividend date at $100, a $10 dividend is declared with respect to the stock, and the taxpayer buys an option to sell the stock for $90, the taxpayer exercising the option is assured of a sales price equivalent to the fair market value immediately after the ex-dividend date, regardless of subsequent market movements affecting the value of the stock. Under current law, the dividends received deduction would be denied with respect to the $10 dividend to prevent such an abusive transaction. If the option is not exercised and the stock is not otherwise disposed of, however, no loss is recognized, the option has not provided the taxpayer with a tax arbitrage opportunity, and there is no reason to deny a dividends received deduction with respect to the $10 dividend.

A similar abuse exists in cases where a corporate taxpayer holds both "long" and "short" positions with respect to stock on the ex-dividend date. Absent a rule denying the dividends received deduction with respect to dividends received when an obligation to make corresponding payments exists regardless of whether a sale or other disposition occurs, a corporate taxpayer would claim that all of the dividends received with respect to the stock are subject to the dividends received deduction, while also deducting against ordinary income the amounts paid (generally equal to the dividends received) with respect to the short position.

The corresponding payment rule as originally enacted was limited to payments made with respect to short positions in "substantially identical stocks or securities." Because taxpayers were attempting to circumvent the statutory rules by acquiring dividend-paying common stock and entering into short sales of convertible preferred stock or convertible bonds of the same issuer and claiming that the positions were not "substantially identical," the Tax Reform Act expanded the corresponding payment rule to include payments made with respect to short positions in substantially similar or related property. In addition, the holding period requirement was extended from 16 days to 46 days, because Congress determined that the 16-day requirement was inadequate to deter dividend stripping (the 91-day holding period for certain preference dividends was retained). Further, the Tax Reform Act provides regulatory authority for the suspension of the holding period with respect to stock for any day the taxpayer has diminished the risk of holding the stock by holding one or more other positions with respect to substantially similar or related property. The Tax Reform Act, however, did not change the requirement that a sale or other disposition occur before the dividends received deduction would be disallowed for failure to satisfy the requisite holding period.

The proposed amendment, contained in section 104(b)(1) of the bill, would disallow the dividends received deduction where the holding period requirement is not met, irrespective of whether there is a sale or disposition of the stock. According to the "Description of the Technical Corrections Act," prepared by the staff of the Joint Committee on Taxation, this provision is intended to eliminate perceived administrative problems caused by the disposition requirement. In particular, present law does not indicate clearly whether the dividends received deduction is denied retroactively to all dividends received with respect to stock that is sold or disposed of before the required holding period is satisfied or whether the dividends received deduction is denied only with respect to the last dividend received prior to the sale or other disposition of the stock. If the former interpretation were to prevail, as assumed by the Joint Committee staff explanation, significant administrative burdens would clearly arise.

We believe that the statute as presently drafted does not provide explicit guidance concerning which dividends are denied the dividends received deduction upon the sale or other disposition of stock before the required holding period is satisfied. The policy underlying the dividends received deduction, however, suggests that present law should be interpreted to deny the dividends received deduction only with respect to dividends that provide the taxpayer with tax arbitrage opportunities. If corresponding payments are not made with respect to a short position in similar or related property, tax arbitrage opportunities are present only when there is a sale or disposition of the stock.

Under the proposed amendment, however, a corporation would be denied the dividends received deduction for all dividends received with respect to shares in a subsidiary or other corporation if the corporation has diminished its risk of loss by holding substantially similar or related property, regardless of whether the stock is held for 20 days or 20 years. While this result is appropriate and required by current law if the corporation also is making corresponding payments with respect to a short position in similar or related property, it is not appropriate in situations where only one dividend payment provides a tax arbitrage opportunity. Therefore, the proposed amendment does not further or clarify the Congressional purpose underlying the holding period requirement applicable to the dividends received deduction. Moreover, the proposed amendment, which would apply retroactively to stock the holding period for which began after the date of enactment of the Tax Reform Act, would impact significantly on corporations that enter into transactions to enhance yield and reduce the risk of market fluctuations with respect to stock held for long-term investment purposes.

In summary, we oppose the proposed deletion of the sale or other disposition requirement with respect to the dividends received deduction. We are not persuaded at this time that risk reduction absent tax arbitrage opportunities is a relevant criterion for purposes of denying the dividends received deduction.

If the Committee decides that some action in this area is necessary, however, we suggest that, rather than the approach adopted in the bill, consideration should be given to reducing a corporate taxpayer's basis in acquired shares, in a manner similar to that provided in section 1059, if the taxpayer does not hold the shares for the required period. Under section 1059, a corporate shareholder's adjusted basis in any share of stock that is held for one year or less is reduced by the nontaxed portion of any extraordinary dividend received with respect to such stock. If the nontaxed portion of an extraordinary dividend exceeds the shareholder's adjusted basis in the stock with respect to which the distribution was made, the excess is treated by the shareholder as gain from the sale or exchange or property. For purposes of determining whether stock has been held for one year or less, the general holding period suspension rules applicable for purposes of the dividends received deduction are applicable. All dividends that have ex-dividend dates within a period of 85 days are treated as one dividend with respect to the dividend-paying stock.

A similar rule could apply to adjust the basis of stock that is sold or otherwise disposed of before a corporate taxpayer has satisfied the requisite holding period. Under such a rule, the basis of the stock would be reduced by the nontaxed portion of all dividends received within a period of 85 days from the date of acquisition of the stock. Consistent with the policy underlying the dividends received deduction limitation, this approach would prevent a corporate taxpayer from creating an artificial loss on the sale or other disposition of the stock equivalent to the amount of the dividends included in the purchase price of the stock.

Multiple Trust Rule

The Tax Reform Act provides that under Treasury regulations two or more trusts shall be consolidated and treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and (2) a principal purpose of the trusts is tax avoidance. The multiple trust rule is effective for taxable years beginning after March 1, 1984. Thus, it applies to existing trusts in taxable years beginning after March 1, 1984.

Although the bill would leave the substantive portion of the multiple trust rule intact, it would amend the effective date of the provision. In particular, section 106(a) of the bill provides that, in the case of any trust that was irrevocable on March 1, 1984, the multiple trust rule would apply only to the portion of the trust, if any, attributable to contributions made to corpus after March 1, 1984.

Prior to 1983, Treasury regulations provided that two or more trusts would be consolidated and treated as one trust under enumerated circumstances similar to the provisions of the multiple trust rule included in the Tax Reform Act. The Tax Court, however, held in 1983 that the Treasury regulations were invalid. In response to the Tax Court's decision, the multiple trust rule was enacted in the Tax Reform Act. Congress was concerned that, without the restrictions provided by the Treasury regulations, it would have been possible under the progressive tax rate structure for a taxpayer to reduce income taxes significantly by establishing multiple trusts for the same or similar beneficiaries. Congress sought to restrict this ability to reduce tax liability by expressly providing a statutory multiple trust rule.

We oppose the provision in the bill that would amend the effective date of the multiple trust rule for two reasons. First, the proposed amendment, in the Treasury Department's view, cannot be considered a technical correction. Rather, the amendment seeks to make a significant substantive change in the scope of the multiple trust rule. As enacted, the provision can operate to consolidate multiple trusts established before March 1, 1984, in the first taxable year beginning after that date. The proposed amendment would drastically reduce the number of trusts to which the provision is potentially applicable. Regardless of whether a broad grandfather rule would have been desirable in the provision as enacted, such an amendment cannot fairly be characterized as a technical correction.

Second, we believe the proposed amendment is overbroad. It must be recognized that the multiple trust rule can operate to consolidate two or more trusts for tax purposes only if, in addition to other requirements, a principal purpose of the trusts is tax avoidance. Accordingly, the proposed change in the effective date provision will provide relief only to trusts established with tax avoidance as a principal purpose. In particular, the amendment would permit taxpayers who established an unlimited number of trusts prior to March 1, 1984 to continue to reduce their tax liability significantly in all future taxable years.

While the Treasury Department is aware of certain classes of trusts for which relief from application of the multiple trust rule might be appropriate, we believe an amendment providing wholesale relief to all trusts created prior to March 1, 1984, many of which may be flagrant attempts artificially to reduce tax liability, is inappropriate and should not be included in the bill. We believe that any unjustified applications of the multiple trust rule can be avoided administratively. Nevertheless, we would be pleased to work with the Committee in drafting a narrower grandfather provision, if the Committee believes such relief should be provided by statute.

Definition of Listed Property

The Tax Reform Act imposed stricter recordkeeping requirements and limited accelerated cost recovery (ACRS) deductions and investment tax credit (ITC) allowances on "listed property." The term "listed property" includes passenger automobiles and other means of transportation, computers and peripheral equipment, property used for entertainment, recreation and amusement purposes and other types of property specified in Treasury regulations. Computers that are "used exclusively at a regular business establishment," however, are not listed property.

Section 112(e)(3) of the bill would provide that the exception for computers used exclusively at a regular business establishment would apply only to computers "owned or leased by the person operating such establishment." Although this provision is consistent with the legislative history of the Tax Reform Act, the Treasury Department opposes this amendment because it is contrary to the purposes of the underlying provision.

The proposed amendment will primarily affect computers owned by employees that are kept at the employer's place of business. If an employee's computer kept at the employer's place of business is classified as listed property, the employee must substantiate claimed business use of the computer under section 274(d) of the Code (rather than section 162 of the Code) and prove that the computer is for the convenience of the employer and is required as a condition of employment to be entitled to any deduction or credit for the computer. Congress imposed these additional requirements on listed property because of concerns that taxpayers were overstating deductions for property of a type that is susceptible to personal use. These concerns were particularly acute in the case of employees claiming deductions for property used in connection with their employment.

The original exclusion for computers kept at a regular business establishment reflected a judgment that the potential for personal use of such property is minimal. The Treasury Department believes this rationale applies equally whether a computer is owned by an employer or an employee. The compliance concerns that prompted Congress to enact stricter limits on listed property are not likely to be as great when an employee keeps a computer at the employer's place of business. Therefore, we recommend that this proposed amendment be deleted from the bill.

Gambling Activities Conducted by Nonprofit Organizations

Section 511 of the Code imposes a tax on the income derived by a tax-exempt organization from the conduct of an "unrelated trade or business." An unrelated trade or business is defined as a trade or business the conduct of which is unrelated to the purpose for which the organization has been granted exemption from Federal income tax. The Tax Reform Act provides that the term "unrelated trade or business" does not include conducting any game of chance by a nonprofit organization if (i) the organization's conduct of the game does not violate any State or local law, and (ii) as of October 5, 1983, there was a State law in effect that permitted the game of chance to be conducted only by nonprofit organizations. We understand that this provision was intended to apply only to gambling activities regularly conducted by nonprofit organizations located in North Dakota.

The Treasury Department opposed enactment of this provision as an inappropriate exception to the statutory definition of the activities that constitute an unrelated trade or business. Moreover, the Treasury Department did not believe it appropriate to enact a change in the substantive law that would apply to organizations located in one particular State without extending the special exemption to similarly situated organizations located in other States.

We understand that, since enactment of the Tax Reform Act, questions have arisen concerning whether this provision applies to States other than North Dakota. Section 133 of the bill would clarify Congressional intent by providing that the special exemption from the general rules defining an unrelated trade or business is available only if the State law restricting the operation of the particular game of chance to nonprofit organizations was originally enacted on April 22, 1977, the date the relevant law was enacted in North Dakota.

Given the Congressional intent to limit this provision of the Tax Reform Act solely to North Dakota, we agree that section 133 of the bill is within the proper scope of a technical corrections bill. We continue to believe, however, that the substantive provision is not a justifiable exception to the unrelated business income tax and that, in any event, the same rule should apply to all similarly situated taxpayers regardless of the State in which they are located. Finally, we note that under the general effective date provision of the bill the proposed amendment would apply as if it had been included in the Tax Reform Act. As described above, however, the provision as enacted applied on its face to nonprofit organizations located in any State in which a proper law was in effect as of October 5, 1984. Because nonprofit organizations located in States other than North Dakota with such laws in effect had no notice that the special exemption did not apply to them, transition rules providing appropriate relief should be adopted if the proposed amendment is enacted.

Definition of "Welfare Benefit Fund"

Section 151(a)(8) of the bill proposes to amend the definition of "welfare benefit fund" to exclude certain experience-rated arrangements between employers and insurance companies so that employer contributions to, reserves under, and refunds and dividends paid pursuant to such arrangements will not be subject to the various limitations on "welfare benefit funds" enacted by the Tax Reform Act. The general policy underlying these limits was to restrict the extent to which employers are able currently to accumulate amounts on a tax-favored basis in "welfare benefit funds" to provide future benefits to employees. (These limitations are commonly known as the "VEBA" rules.)

At this time, we oppose the proposed amendment and instead recommend that the original decision of Congress on this issue--that such arrangements be treated as "welfare benefit funds" only to the extent provided in Treasury regulations--be permitted to stand.

The Tax Reform Act generally limited the favorable tax treatment of welfare benefit funds by precluding the employer from currently deducting contributions to a "fund" to provide future benefits to active employees and by subjecting fund income to unrelated business income tax where the fund's reserves at year-end are in excess of actuarially justified levels to cover claims incurred but unpaid as of the end of such year. Certain modifications to these rules were made where an employer is accumulating amounts to provide post-retirement life insurance or health benefits to employees. The Tax Reform Act also provided that if any portion of a welfare benefit fund reverts to the benefit of the employer maintaining the fund, the amount of the reversion is subject to a 100 percent tax.

The Tax Reform Act contained a three-prong definition of the term "fund." First, any social club, voluntary employees' beneficiary association, supplemental unemployment compensation benefit trust, or group legal services organization that is tax-exempt is a "fund." Second, any trust, corporation, or other organization not exempt from income tax is a "fund"; this rule was directed at taxable trusts and similar organizations.

Third, and most important for present purposes, the Tax Reform Act provided that "to the extent provided in regulations, any account held for an employer by any person" would be a "fund." This third prong was directed principally at accounts held by insurance companies whereby the insurance company effectively holds an employer's funds on a tax-favored basis to discharge the employer's future welfare benefit obligations. This arrangement enables the employer to gain the benefit of the favorable tax treatment provided to insurance company reserves.

Even though no regulations have been issued causing any account involving an insurance company to be treated as a "fund" under the third prong of the definition, section 151(a)(8) of the bill proposes to amend the third prong to exclude certain amounts held for the benefit of an employer by an insurance company if (i) there is no guarantee of a renewal of the contract and (ii) the only payments to which the employer or employees are entitled, other than current insurance protection, are experience-rated refunds or policy dividends that are not guaranteed and that are determined based upon factors other than the amount of the welfare benefits paid to (or on behalf of) the employees of the employer. The bill would make this exemption contingent on the employer including any experience-rated refund or policy dividend with respect to a policy year in income in the employer's taxable year in which the policy year ends.

The proposed amendment would thus exempt certain experience-rated arrangements with insurance companies from the definition of "fund". At this time, we do not believe that the proposed amendment is appropriate for several reasons.

First, the question of whether an account involving an insurance company should be treated as a "fund" or whether an employer's arrangement with an insurance company is bona fide insurance is a complex policy issue that requires significant in-depth study. Indeed, in this regard, we understand that certain insurance companies are now proposing changes to the amendment, indicating further the complexity of the issue and the importance of acting only after a complete examination. The insurance industry is concerned that the definition of "fund" not be overbroad. We are similarly concerned, however, that an inappropriate narrowing of the scope of the enacted limits may effectively permit insurance companies to offer arrangements and the associated tax advantages to employers that are not available on a self-funded or self-insured basis and thus may create significant competitive advantages for insurance companies over self-insured arrangements.

In the Tax Reform Act, Congress recognized that the "fund" issue could be properly resolved only after an intensive examination of the various arrangements offered by insurance companies. Unfortunately, the Treasury Department has only begun its examination of the extent to which employers' arrangements with insurance companies should be treated as "funds." We hope to be able to meet with insurance industry representatives over the next several weeks to discuss and examine the proposed amendment and the related issues more closely. Thus, we are not yet able to determine whether the proposal focuses on the appropriate factors or draws the proper distinctions. After the meetings, however, we will be better able to evaluate the proposal and to make specific recommendations regarding its substantive effects.

Second, we understand that the primary objection raised by insurance companies to treating certain experience-rated arrangements as "funds" is that a refund or policy dividend would be a reversion subject to a 100 percent excise tax. We concede that the reversion tax provision may be read to apply to reasonable and bona fide premium refunds and policy dividends. However, such payments are not within the scope of the original policy underlying the reversion tax. Thus, we would not object to amending the excise tax provision to clarify that reasonable and bona fide premium or contribution refunds and policy dividends, if taken into income by the employer in the year to which the refund or dividend relates, would be exempt from the 100 percent reversion tax.

Third, we understand that there is concern about the chilling effect the existing rule is having on the ability of the insurance companies to market experience-rated arrangements to employers. Evidently, some claim that employers are reluctant to enter into experience-rated arrangements due to their fear that such arrangements will be treated as "funds."

We have not received any data in support of this claim. Thus, we are unable to determine whether the claim is supported by the facts. In addition, given the complexity of the issues, the variety of the arrangements offered by insurance companies, and the vagueness of the proposed amendment, we are not convinced that the proposal would succeed in eliminating the claimed chilling effect. Nevertheless, we would not oppose amending the third prong of the "fund" definition to provide that, with the exception of certain arrangements that are commonly considered to be "funds" (e.g., retired lives reserves), an account held by any other person (such as the experience-rated arrangements that are within the proposed amendment) will not be treated as a "fund" before six months following the issuance of final regulations treating the account as a "fund." Such a delayed effective date, tied to final rather than proposed regulations, should be more effective than the proposed amendment at eliminating any current chilling effect involving employers' willingness to enter into experience-rated arrangements with insurance companies.

Qualified Employee Discounts

Under section 132 of the Code, as added by the Tax Reform Act, a qualified employee discount is, within certain limits, excluded from an employee's gross income. An employee discount is the "amount by which the price at which the property or services are provided to the employee by the employer is less than the price at which such property or services are being offered by the employer to customers." To be qualified, an employee discount must be with respect to property (other than real property or personal property of a kind held for investment) or services that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. If a discount does not fall within the definition of an employee discount, it cannot be a qualified employee discount and is includable in gross income (unless excludable under another statutory provision).

Section 153(a)(2) of the bill would amend the definition of qualified employee discount so that a discount would not be qualified unless the property or services provided by the employer are provided "to an employee for use by such employee." We believe the proposed amendment is an appropriate technical correction, which conforms the requirements of a qualified employee discount to the requirements of the related provisions governing no-additional-cost services. A no-additional-cost service, which also is excludable from an employee's gross income, must be a service provided by an employer to an employee "for use by such employee."

In addition, the technical correction is consistent with the structure of section 132. In particular, section 132(f)(2) provides that, for purposes of the no-additional-cost service and qualified employee discount provisions, use by an employee's spouse or dependent child shall be treated as use by the employee. If it were not required that a qualified employee discount must be limited to property or services provided for use by the employee, section 132(f)(2) would be meaningless as applied to qualified employee discounts.

The proposed amendment also is consistent with the statutory principle that only a certain class of employees is eligible for a qualified employee discount. If there were no requirement that the property or service be provided for the use of the employee, then an employee in the appropriate line of business of the employer could act as a conduit for anyone else, including, for example, an employee in a line of business not eligible for the qualified employee discount. In other words, the conduit employee could make the discounted purchase and immediately resell the property or the right to the service to another individual for the discounted price. Allowing the exclusion in such a situation would be inconsistent with the statutory limitations on the employees eligible for a qualified employee discount.

We note that in light of the statutory structure and underlying rationale of section 132, the same result could be reached by regulation without a technical correction. Nevertheless, we believe that this statutory clarification is appropriate.

We are, however, concerned with two aspects of the technical correction. First, we do not believe that the qualified employee discount exclusion should be denied where an employee gives property to a third party without any consideration. For example, if an employee working in a department store buys an item at a discount and gives it to his mother for Mothers' Day, the qualified employee discount exclusion should be available. Giving property or the right to a service to a third party as a gift should be considered use of the property or service by the donor. Again, although we believe we could reach this result without additional legislative guidance, we suggest that report language clarify this point.

Our other concern relates to the employer's withholding and employment tax obligations. If an employee is purchasing property as a conduit for a person who is ineligible for a qualified employee discount, the employee generally would be taxable on the discount. However, the employer may not know that the employee is reselling the property. In such cases, the employer does not have a withholding or employment tax obligation with respect to such taxable discount as long as at the time the discount was provided it was reasonable to believe that the employee would be able to exclude the discount from income. Employers must be able easily to determine under what circumstances it is reasonable to believe that the employee is not reselling the property and thus making the discount taxable. We believe that an employer should not be required to police use of the discounted property or services by employees as long as the employer has a bona fide policy, clearly communicated to employees, against resale by employees and the employer is not aware of facts that indicate this policy is not being observed. Again, appropriate committee report language would be helpful to confirm this point.

Interest Exclusion for ESOP Loans

The Tax Reform Act included a provision that permits banks, insurance companies and certain other lending corporations to exclude one-half of the interest earned on qualifying loans used by ESOPs or corporations to acquire employer securities. The exclusion applies to loans used to acquire employer securities on or after July 18, 1984.

Section 265(2) of the Code denies a taxpayer a deduction for interest on debt "incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle." The Internal Revenue Service has made an administrative determination that a bank's liabilities to depositors are not incurred to purchase or carry tax-exempt obligations owned by the bank.

Section 291, however, disallows 20 percent of a bank's interest expense allocable to indebtedness "incurred or continued to purchase or carry obligations acquired after December 31, 1982, the interest on which is exempt from taxes." Section 154(c)(1) of the bill would amend section 291(e) to exclude interest exempt from tax under section 133 from the scope of section 291.

The Joint Committee Staff's General Explanation ("General Explanation") to the Tax Reform Act states that section 265 does not apply to interest on qualifying ESOP loans. This result is arguably correct for banks because interest exempt under the special ESOP provision included in the Tax Reform Act should be treated in the same manner as wholly tax-exempt interest on municipal bonds. The General Explanation, however, also states that section 291 does not apply to such loans, but notes that a technical correction would be necessary to exempt such interest from the provisions of section 291.

Reflecting the intention noted in the General Explanation, section 154(c) of the bill provides that interest on an obligation eligible for the exclusion available for ESOP loans will not be treated as tax-exempt interest for purposes of section 291. We believe that the proposed amendment is inconsistent with the purpose of section 291 and essentially treats interest income received by a bank that is exempt from tax under this provision more favorably than interest on municipal bonds. Interest received by banks that is exempt because the proceeds are used by a corporation or an ESOP to acquire employee securities should be treated in the same manner as interest on municipal bonds. Therefore, the Treasury Department opposes the proposed amendment to section 291(e).

Employer-Operated Eating Facilities

The Tax Reform Act expressly provides that gross income includes fringe benefits except as otherwise provided in the Code. The Treasury Department is concerned with the administrability of this rule as applied to meals provided to employees in subsidized employer-operated cafeterias. Although no provision relating to this problem is currently included in the bill, we suggest that the Committee consider an additional technical correction to simplify its administration.

Section 132 excludes from income any de minimis fringe. Section 132 provides explicitly that the operation of an eating facility by an employer for its employees is treated as a de minimis fringe if the facility is located on or near the business premises of the employer and the revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. This special cafeteria rule does not apply to officers, owners, or highly compensated employees, unless access to the facility is available on substantially the same terms to a nondiscriminatory class of employees.

If an employer-operated cafeteria fails either the direct operating cost test or the nondiscrimination test (and does not fall within the special section 119 exclusion for meals provided on the employer's premises for the employer's convenience), the value of the meals provided (net of any employee payments) will be taxable income to the employee. Accordingly, employers and employees will have to determine who received meals and how much those meals were worth.

We have explored the possible creation of administrative safe harbor valuations to eliminate the need for such detailed accounting, but have discovered significant problems concerning valuation of the total meals provided and allocation of the income (the excess of the total value over total revenues received), among the employees. For example, allocation of income pro rata among all employees would be unfair to employees who do not use the cafeteria frequently. On the other hand, although allocation of the income among all employees based on the number of times each used the cafeteria might be acceptable, many employers do not currently monitor who eats at the facility and the adoption of such a monitoring system would be burdensome and costly.

In light of these substantial administrative problems, we recommend consideration of a technical correction that would exclude from income any meals provided to an employee by his or her employer at an eating facility operated by the employer on or near the employer's premises, regardless of whether provided for the convenience of the employer. In conjunction with this amendment, we suggest an excise tax on the employer with respect to the subsidized portion of the meals. The excise tax rate would be set at a level that would approximate the taxes that would have been paid by the employees. Because the excise tax represents a proxy for the forgone employee taxes, consideration could be given to establishing one rate for facilities that do not discriminate in favor of officers, owners, or highly compensated employees and a higher rate for cafeterias that do not comply with the nondiscrimination provisions. The higher rate would be appropriate for cafeterias that fail the discrimination tests because officers, owners, and highly compensated employees are generally in higher income tax brackets than other employees. In our view, an excise tax regime would accomplish the intent underlying the fringe benefit provisions enacted in the Tax Reform Act, while avoiding significant administrative difficulties.

Interest Paid to Foreign Persons

The Treasury Department proposes additional provisions for the portion of the bill relating to the 30 percent withholding tax on U.S. source interest paid to foreign persons. The Tax Reform Act generally repealed this tax with respect to interest on portfolio obligations issued after July 18, 1984.

The most significant proposal would provide that only interest paid on an obligation issued pursuant to a public offering would qualify as "portfolio interest" eligible for repeal of the 30 percent tax. The legislation would be drafted to ensure that interest on debt that is in substance publicly offered and traded abroad would enjoy the exemption.

It has been suggested that this proposal does not constitute a technical correction. If this is determined to be correct, we nevertheless regard the proposal as good tax policy and would support its inclusion in another legislative vehicle if that were considered more appropriate.

The Treasury Department believes that the purpose of the repeal legislation was to provide direct access to the Eurobond market for U.S. borrowers. When Congress in effect repealed the withholding tax for several years beginning in 1971, it limited the exemption to interest on underwritten public issues of debt obligations in the Eurobond market. This market consists of publicly offered obligations which trade in an active secondary market. It does not include trade indebtedness and privately placed obligations, which generally are exempted by treaty provision.

The Treasury Department opposes unilateral repeal of the 30 percent tax on interest paid, for example, on trade indebtedness and obligations issued in private placements for two reasons. First, the policy basis for unilateral repeal with respect to publicly offered obligations does not apply to such obligations. Publicly offered obligations trade in an active secondary market. That is, the original holder of a publicly offered obligation may sell it to another person who lives in another country, who in turn may sell it to a third person who lives in yet a third country. Any or all of these countries may have a tax treaty with the United States which eliminates the U.S. withholding tax. There is no way, however, for the issuer of the obligation to ensure that it will be held by only residents of treaty countries who will not be taxed on the interest. The only way to ensure that foreign persons will not be taxed on publicly offered obligations, and that these obligations will be able to trade freely in the Eurobond market, is to eliminate the tax by statute.

This rationale simply does not apply to obligations placed with a few private holders or to trade indebtedness. If U.S. issuers of such obligations wish holders of their debt obligations to avoid the U.S. withholding tax, such issuers can feasibly target the obligations to residents of treaty countries. In this context, we believe it inappropriate as a matter of tax policy to exempt income from tax unilaterally, in the absence of overriding policy reasons. This is particularly true in the current fiscal environment.

The second reason we oppose repeal of the 30 percent tax on interest paid on trade indebtedness and privately placed obligations is that other countries generally have not repealed their interest withholding taxes on such obligations. Exemption for such obligations should be negotiated through tax treaties, whereby reciprocal treatment can be obtained for U.S. sellers of goods and U.S. persons wishing to undertake private borrowings.

In addition to the foregoing proposal, Treasury would suggest some minor clarifications relating to the effective date of repeal and certifications required for registered obligations. We would be pleased to discuss these issues with Committee staff.

Broker Reporting of Substitute Payments

The Tax Reform Act amended section 6045 by adding section 6045(d). This new provision requires brokers to furnish their customers with a written statement regarding certain substitute payments received by brokers on behalf of their customers.

Section 6678 generally imposes a penalty in the case of each failure to furnish a statement pursuant to various information reporting provisions, including section 6045(b). The Tax Reform Act inadvertently neglected to amend section 6678 specifically to provide a penalty for failure to furnish the statement required by section 6045(d). Similarly, section 6652 generally imposes a penalty of 5 percent of the gross proceeds required to be reported for intentional failures to file returns required by section 6045. Because section 6045(d), unlike section 6045 generally, requires "payments," not gross proceeds, to be reported, section 6652 appears inapplicable to a broker that intentionally disregards the return requirement under section 6045(d).

No changes correcting these oversights are included in the bill. Accordingly, we suggest that conforming amendments be made to sections 6652 and 6678.

TECHNICAL CHANGES TO THE RETIREMENT EQUITY ACT OF 1984

In 1984, Congress enacted significant legislation altering the tax-qualification requirements and the corresponding labor provisions for employer-maintained profit-sharing, stock bonus, pension, and annuity plans to provide greater protection to plan participants, to surviving spouses of deceased participants, and to former spouses of plan participants. The Administration supported the Retirement Equity Act and continues to support the policies reflected therein.

The Finance Committee, according to the press release announcing this hearing, is receiving comment on technical corrections to the Retirement Equity Act of 1984. The Committee, however, is not at this time considering a bill containing specific amendments. We believe that technical amendments to the Retirement Equity Act are necessary to clarify certain of the original provisions and to resolve certain issues that were not adequately addressed in the original legislation. Unfortunately, however, we have not yet completed our review of the Act to identify the amendments that should be made. We plan to complete this review and report our recommendations to you shortly.

We note, however, that a bill to make technical corrections to the Retirement Equity Act has been introduced in the House (H.R. 2110). As we testified before the Ways and Means Committee on May 16, 1985, although we generally support the provisions in H.R. 2110, we oppose two of the proposals contained in that bill. One of these two proposals would modify the rules governing whether a qualified plan may make a payment to an alternate payee (e.g., a former spouse) under a qualified domestic relations order before the plan participant has separated from service. The other proposal that we oppose would permit a spouse of a participant to waive irrevocably his or her right to consent to the participant's selection of a beneficiary of any remaining plan benefits upon the participant's death. We will discuss these issues further once we have completed our review.

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This concludes my prepared statement. I would be pleased to respond to any questions.

The CHAIRMAN. I have no questions of you. Senator Symms? Any questions?

Senator SYMMS. Yes. Thank you, Mr. Chairman. Mr. Mentz, the question I want to ask you is, in section 108 of the 1984 act, there was a section in the bill which was a technical correction to clean up what had happened in 1981 with respect to tax treatment of regulated futures contracts. When the system went from the old system to mark to market and the IRS had, as you know, targeted in on straddle positions where people were either converting short-term gain into long-term gain in paying the capital gains rate, or else trying to defer the taxes on over into the next taxable year. So, the Congress addressed that in 1984 to try to clean it up and to end all the uncertainty, but we passed the law, and it was signed by the President. The Internal Revenue Service acts as though nothing happened. Do you have any plans on what is going to happen there? Are we going to go ahead and continue to harass the taxpayers even against the wishes of the Congress? I mean, they have to hire lawyers all the time to fight these things. Do you want to comment on that?

Secretary MENTZ. I will be glad to comment, Senator Symms.

Senator SYMMS. There are two sets of taxpayers here. There are the people who earned money in some other vocation and moved in and used the futures market as a tax—to try to reduce their tax burden. And then there are the legitimate traders, and they seem to be the target of the IRS, and for what reason, I still haven't figured out.

Secretary MENTZ. All right. You have three or four questions wrapped up in the general question. Let me try to answer it. In 1981, I believe at the institution of the Senate Finance Committee, there was this mark-to-market provision enacted which really did curtail a serious problem where a taxpayer would engage in a straddle transaction. He would frequently take a capital loss on one leg of the straddle in 1 year, and then defer the gain until the next year, and by continuing to roll it you can get the benefit of the loss and never pay tax on the gain. So, there clearly was a problem here which you addressed and addressed frontally. And the issue that you are raising is: What about pre-1981?

Senator SYMMS. That is correct.

Secretary MENTZ. And that was addressed in the 1984 legislation. The effect of that, as I understand it, the intention—although it is not crystal clear—the intention was to take care of the dealers who pre-1981 were engaged in these types of transactions as their business. And under those circumstances, basically what the legislation said was prior to the effective date of the Economic Recovery Tax Act, effectively we would let bygones be bygones. Recently the *Miller* case was decided in the Tax Court which effectively held that the 1984 legislation protects not only dealers but also protects anyone who has engaged in a straddle transaction as a means of effectively providing tax shelter. That is a very broad decision and a very troublesome one to the IRS. I know that Commissioner Eggar and Chief Counsel Goldberg are very concerned about that decision. They are trying to develop what their litigating strategy is to be and what their overall strategy is to be with respect to what do they do about the nontraders, the tax-shelter individuals, who engaged in straddle transactions pre-1981.

Senator SYMMS. The question I am trying to get answered is: What is wrong with going by the law?

Secretary MENTZ. Which law?

Senator SYMMS. The commodity transactions had been treated in a certain way from 1938 through 1977, and then it is 1977, 1978, 1979, and 1980 tax years that are in question. 1981 was the year the law changed, and most of the commodity transactions went to mark to market.

Secretary MENTZ. That is right.

Senator SYMMS. So, we have these 4 or 5 years. Why not go back to 1971 or 1972 or 1973? I mean, all of a sudden we have some very good people who are law-abiding citizens who are being harassed, in my view, just like the gestapo—the way they are treated.

Secretary MENTZ. Senator, the law and the case law relating to tax years before 1981 has been coming out in favor of the IRS. Some of these straddles that are engaged in on a purely tax shelter basis have not held up, but now that the 1984 act has come along, the *Miller* case complicates the matter. Taking into account the 1984 act retrospectively, *Miller* seems to suggest that these straddles are OK, not just for the dealer but for everybody. Now, I think the IRS, and certainly the Treasury, agree that as to the dealer, which is what we thought we were dealing with in the 1984 act, that is taken care of and there really should be no argument about it. As to the individual who is not a dealer and not a trader but just using this straddle as a shelter, it is very troublesome because there is an awful lot of money involved, and I think that issue is just simply not resolved, Senator.

Senator SYMMS. I understand that, and I do believe that it was primarily the intent of this committee and the Congress to address the question of the legitimate dealers who are involved in market discovery for an entire range of commodities which is a very important part of the way these different commodities are marketed—with price discovery, I should say—but if that is the case and what you are saying to me is the case, why can't you direct the Internal Revenue Service to just fold up their tents out in Skokie, IL, and close that thing down and quit harassing those people?

Secretary MENTZ. Quit harassing the dealers?

Senator SYMMS. Yes.

Secretary MENTZ. Oh, I think that is well in the works, Senator. I don't think we have any disagreement on that question. The real question that we are worried about and the IRS is worried about is what about people who are not dealers. But on the dealer subject, I agree with you.

Senator SYMMS. I understand that totally, but on the other side of it, the market makers who have—most of these people if you investigate their tax returns—been paying taxes every year, and in some cases very high taxes. but it seems like there can be no discrimination on the part of the IRS. You know, I can see what you are saying. If somebody has purposely gotten in the straddle market, that is why Congress addressed it in 1981 to just avoid paying taxes. That is not—no one here agrees with that.

Secretary MENTZ. That is right.

Senator SYMMS. But the normal transactions that take place where these people would make thousands of trades in a year, what has happened is they are going back and saying this trade is an economic trade and this one isn't, and they are doing this to legitimate dealers.

Secretary MENTZ. Senator, I agree with you, and to make sure that it gets taken care of, I will personally get in touch with the IRS and make sure the point is covered.

Senator SYMMS. Thank you very much.

Secretary MENTZ. Surely.

The Chairman. Senator Baucus?

Senator BAUCUS. No questions, Mr. Chairman.

The Chairman. Senator Grassley?

Senator GRASSLEY. No questions, Mr. Chairman.

The Chairman. Senator Chafee?

Senator CHAFEE. Mr. Mentz, on the 30 percent withholding, is the President going to clarify the regs on the mortgage pass-through certificates so they will be eligible for the repeal.

Secretary MENTZ. Yes, sir.

Senator CHAFEE. The other thing is when we did the repeal of the 30 percent, I think it was pretty clear that we were just dealing with publicly traded securities. We weren't concerned with private issues. So, what is the problem now? Why are some interpreting this that private issues qualify?

Secretary MENTZ. I would say that certainly the Treasury would agree with you. There is a disagreement. Congressman Gibbons has a feeling the other way, and that is the reason that I would like to see this corrected. It seems to us that as a policy matter there is no question that it ought to be limited to public offerings. And by the way, public offerings needs to be defined in a way that covers transactions that are in substance public offerings but, particularly, in Switzerland, there are transactions handled by banks where they are called private placements, but in reality they are offered to the public. That is a technical point we would take care of, but I am glad to hear you affirm the position on the limitation to public offerings.

Senator CHAFEE. I am not sure we do now, but do you have any suggestions, quickly?

Secretary MENTZ. Yes. I think we ought to get a statutory language up that would do as we suggest and run it up the flagpole and see if they salute.

Senator CHAFEE. My fear is, Mr. Chairman, that we are going to be bedevilled here on what is technical and what isn't technical all morning, if we are through in the morning. We will take a look, and maybe Congressman Gibbons won't salute, but we will try. Thank you. Thank you, Mr. Chairman.

Secretary MENTZ. Thank you, Senator.

The Chairman. Senator Long?

Senator LONG. No questions, Mr. Chairman, at this time.

The Chairman. Senator Symms, do you have any questions now? I mean, Senator Grassley?

Senator GRASSLEY. No, I don't have any questions.

The Chairman. Mr. Secretary, thank you very much.

Secretary MENTZ. Thank you, Mr. Chairman.

The Chairman. Now, we will move to a panel. The first panel consists of Mr. Daniel Maclan, the vice president and general counsel for the Dreyfus Corp., accompanied by Mr. William Morris; Mr. Martin Ginsburg, professor at Georgetown University; Mr. Mac Asbill of Sutherland, Asbill & Brennan; and Mr. Richard Valentine of Seward & Kissel, on behalf of Baldwin Securities. Mr. Maclean, why don't we start with you? All of your statements will be in the record, and we will hold you to our 3 minutes testimony rule.

STATEMENT OF DANIEL C. MACLEAN, ESQ., VICE PRESIDENT AND GENERAL COUNSEL, DREYFUS CORP., NEW YORK, NY

Mr. MACLEAN. I will try to be brief.

The Chairman. Thank you, sir.

Mr. MACLEAN. Good morning. My name is Daniel C. Maclean. I am vice president and general counsel of the Dreyfus Corp., located in New York City. I am appearing before this committee today on behalf of that corporation. I am accompanied here by Bill Morris of the law firm of Rogers & Wells. We are here today to ask the committee to consider a technical amendment to section 904(d)(3) which was added by the Tax Reform Act of 1984. I would ask that my written submission be included in the record of these hearings. The legislative intent of Section 904(d)(3) was to prevent taxpayers from obtaining a tax benefit where funds are invested through a mutual fund. We submit that the intent of the Congress was not to create a tax detriment for investments made through a mutual fund. Unfortunately, the statute is not clear as to whether certain kinds of investments can be made directly without any tax detriment through a mutual fund. For example, a taxpayer may directly invest the working capital of a foreign subsidiary corporation and interest received by the taxpayer is not limited in its foreign tax credit benefits. However, under the 1984 act, it is not clear whether the same taxpayer could invest the same working capital through a mutual fund with the same foreign tax credit results. Any interpretation providing different results depending on whether the investment is direct or indirect through a mutual fund is grossly discriminatory without any clear purpose. We believe such an interpretation is inconsistent with the objective of the statutory change made in 1984. That change was an attempt to make the use of a mutual fund for investments result in tax consequences no different than if those same funds were directly invested. Equality and certainty of tax treatment are essential. Accordingly, we ask that you make it clear that the change enacted in 1984 does not override the general longstanding provision that interest income on working capital is not subject to the 1984 rule even when interest income is received through a mutual fund as dividends. This clarification is entirely consistent with existing law, is wholly neutral, and simply gives taxpayers with foreign operations an opportunity to choose from a wide array of financial management choices without being driven or limited by different tax consequences.

The CHAIRMAN. Thank you, sir. Professor Ginsburg? I might say before he testifies that he has been most helpful over the years in calling to our attention technical corrections that needed to be made or, on occasion, commenting on some others that were being suggested that were not necessarily technical corrections. And in addition, he has given hours and hours on a Subchapter C report that this committee has issued, and Professor, I appreciate very much the volunteer time you have given us.

[The prepared written statement of Mr. Maclean follows:]

TESTIMONY OF DANIEL C. MACLEAN BEFORE THE SENATE FINANCE COMMITTEE ON H.R. 1800

My name is Daniel C. Maclean. I am Vice-President and General Counsel of the Dreyfus Corporation located in New York City. I am appearing before this committee today on behalf of the Dreyfus Corporation. I am accompanied by our counsel on this matter, William Morris of the law firm of Rogers & Wells, Walter Pozen, of the law firm of Stroock & Stroock & Lavan and William M. Daley of the law firm of Mayer, Brown & Platt. We are here today to ask the committee to consider a technical amendment to section 904(d)(3) which was added by the Tax Reform Act of 1984.

This is a complex area requiring painstaking review and analysis. One of the leading authorities on corporate taxation, Professor James Eustice has noted in his book The Tax Reform Act of 1984 that taxpayers subject to section 904(d)(3) will face the burden of having to read, understand and apply its rules. We have undertaken that burden, share Professor Eustice's view, and have concluded that technical modifications are absolutely necessary.

The amendment we propose would clarify the operation of Section 904(d)(3) and further the legislative intent of the section by precluding any new benefit or detriment through the use of a financial intermediary.

Prior to the Tax Reform Act of 1984, taxpayers could circumvent the general restrictions imposed on certain interest income earned abroad by causing foreign subsidiaries or regulated investment companies to earn interest income on their behalf and then distribute that income to them as dividends. Section 122 of the Tax Reform Act of 1984 added section 904(d)(3) to prevent U.S. taxpayers from converting separate limitation interest income to foreign source income for foreign tax credit computation purposes.

The precise operation of this new section is somewhat ambiguous. Section 904(d)(3) states that dividends or interest paid or accrued by a designated payor corporation "shall be treated as interest income described in paragraph (2)". Paragraph (2) states that the separate limitation will apply to all interest other than four categories listed in that paragraph.

One interpretation, literally reading the statute, is that dividends or interest paid or accrued by a designated payor corporation are to be treated as interest income described in paragraph (2) in the sense that such income is tested under paragraph (2) and interest or dividends not coming within one of the four exceptions is separate limitation interest.

The other possibility is that section 904(d)(3) deems any dividend or interest paid or accrued by a designated payor corporation to be separate limitation interest and not within one of the four exceptions of paragraph (2).

Either of these two interpretations seem to us to produce unintended and incongrous results.

The first interpretation calls for a testing under paragraph (2) of interest at the taxpayer level. This interpretation enables some taxpayers, through the use of an intermediary, to receive interest outside of the separate limitation which prior to the 1984 Act would have been treated as separate limitation interest. For example, suppose a 10 percent U.S. shareholder receives dividends from its foreign subsidiary. The foreign subsidiary makes loans to unrelated third parties. These loans are not made in a transaction directly related to the active conduct of a trade or business nor is the subsidiary in the banking business. Presume also that more than 10 percent of the subsidiary's earnings and profits are attributable to separate limitation interest. Under section 904(d)(3) the interest received by the subsidiary on these loans "shall be treated as interest income described in paragraph (2)". Under the first interpretation the dividends recharacterized as interest would be tested under section 904(d)(2) and would be excepted from separate limitation treatment under section 904(d)(2)(C) as received from a corporation in which the taxpayer owns at least 10 percent of the voting stock. This result does not comport with the general intent of section 904(d)(3) that the use of an intermediary should not result in tax consequences different than those consequences which would have resulted had the transaction been conducted directly.

The second interpretation, which would deem any dividend or interest paid or accrued by a designated payor corporation as subject to the separate interest limitation, also presents what we believe to be an unintended result. For example, suppose a taxpayer invests working capital (related to the active conduct by the taxpayer of a business in England) in a regulated investment company. The regulated investment company in turn makes loans to unrelated third parties. Under the second interpretation interest received by the regulated investment company is deemed to be interest treated as separate limitation interest. The exceptions listed in section 904(d)(2) are not applied. This result does not comport with the general intent of section 904(d)(3) in that the use of an intermediary should not result in tax consequences different than those consequences that would have resulted had a transaction been conducted directly. Specifically, had the taxpayer invested its working capital directly, the interest received would not have been separate limitation interest because it is excepted in section 904(d)(2)(A).

The operation of section 904(d)(3) must be made clear and must not create any new benefit or detriment where an intermediary is used. Accordingly, we suggest that the language of section 904(d)(3)(A) and (B) be amended to provide that dividends and interest paid or accrued by designated payor corporations be treated as interest income described in paragraph (2) without regard to subparagraphs (A) through (D). This language makes clear that the exceptions of paragraph (d)(2) will not apply to the recharacterized dividends in the hands of the taxpayer. This will preclude the creation of any new benefit through the use of an intermediary. In addition, we suggest adding a new subparagraph (K) to section 904(d)(3) providing an exception for taxpayers investing working capital. This language will preserve for taxpayers the ability available prior to the 1984 Act to invest working capital of an active trade or business in a foreign country through a financial intermediary. In sum, the technical corrections suggested insure the implementation of the legislative intent of economic neutrality. The various forms of making investments directly or through an intermediary will thus not be driven by different tax consequences.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Professor GINSBURG. Thank you very much, Mr. Chairman. As usual, as an academic, like all academics, I represent truth and justice, and I do not have a client this morning. [Laughter.]

In the written statement I have suggested six or seven technical corrections, all of them added starters. They are not in the bill at present. It would seem to me that they ought not be controversial, but are interesting. As an instance, in the 1984 Act Congress appears quite inadvertently to have created an opportunity of really large size for the benefit of wealthy tax avoiders whose leveraged tax shelters have gone sour, and a smaller related tax avoidance opportunity for certain installment sellers. Amazingly, the new loopholes appear in Section 1041 which, on its face, has absolutely nothing to do with this subject. It deals with interspousal transfers in happy marriages and in divorces. Nonetheless, as I have attempted to show in the written statement, if the tax bar gets loose with the provision as written it will do marvelous things. I think the proper correction is easy to make and will offend no one other than those who hope to get out of leaky tax shelters. I might add that bluebook—the Joint Committee staff production at the end of 1984—makes reference to the section 1041 problem in a footnote. It says that Congress did not intend that this sort of scheme should work but, unfortunately, as far as I can see, the technical correction hasn't been made in the statute, and I think ought to be.

Another opportunity for tax avoidance in the 1984 Act comes out of changes in tax accounting between partners and partnerships, Sections 267 and 707(a). Those specific changes seem to me very sensible, but this centripede has a lot of feet and there is a third shoe to drop. It relates to section 707(c), a guaranteed payment arrangement. Again, as presented through an example in the written statement, it is now possible—if you don't make the technical change—annually to allocate designated amount of income between partners in almost any way they wish. That notion was discredited by the Tax Court years ago in a case called Kresser. It suddenly comes back to life. It ought to be put back to death.

The other suggestions I have made are all related, I think, although perhaps not obviously so. In the 1984 Act, Congress made a number of changes, in various places, in the definition of the terms "control" or affiliation. In the technical corrections bill as it is in front of you, you propose some very important technical corrections to these 1984 Act changes, but I think two are left out. One, a small item, is in Section 338, the other, a very large item, relates to certain transactions which alternately may be cast as "D" reorganizations or 304 transactions. Since I have burdened you with all of the rest of it in the written statement, and my time is up, I will leave it there.

The CHAIRMAN. Thank you. Mr. Asbill?

[The prepared written statement of Professor Ginsburg follows:]

STATEMENT OF MARTIN D. GINSBURG
BEFORE THE
SENATE FINANCE COMMITTEE
ON S. 814
JUNE 5, 1985

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS MARTIN D. GINSBURG. I AM A PROFESSOR OF LAW AT GEORGETOWN UNIVERSITY LAW CENTER WHERE I TEACH VARIOUS SUBJECTS IN THE FIELD OF FEDERAL TAXATION. OVER THE PAST FIFTEEN OR SO YEARS IT HAS BEEN MY PRIVILEGE TO TESTIFY BEFORE THE SENATE FINANCE COMMITTEE ON A NUMBER OF OCCASIONS, AT TIMES AT YOUR REQUEST, AT TIMES ON BEHALF OF A BAR ASSOCIATION GROUP, MORE OFTEN SIMPLY OUT OF AN INTEREST IN THE SUBJECT, BUT NEVER ON BEHALF OF A CLIENT. I APPEAR TODAY AS A DISINTERESTED WITNESS BUT NOT, I PROMISE, AN UNINTERESTED ONE.

THE COMMITTEE TODAY FOCUSES ON CORRECTING, AT LEAST TECHNICALLY, LAST YEAR'S MAJOR TAX LEGISLATION. THE WAYS AND MEANS COMMITTEE EARLIER MET TO CONSIDER ITS COMPANION TECHNICAL CORRECTIONS BILL, H.R. 1800, AND THIS COMMITTEE OF COURSE HAS AT HAND THE COMMENTS THAT WERE SUBMITTED THERE. I DO NOT PROPOSE TO REPEAT THEM AND, THIS MORNING, WILL CONCENTRATE ON A FEW CONCERNS NOT PREVIOUSLY VENTILATED. ALTHOUGH THESE CONCERNS RELATE TO DIFFERENT SEGMENTS OF THE CODE, THERE IS A COMMON THEME. IN EACH CASE THE 1984 LEGISLATION, BENT ON ACHIEVING A RATIONAL TAX RESULT, FELL VICTIM TO THE INORDINATE COMPLEXITY OF THE TAX LAW.

A PERCEIVED PROBLEM WAS ACCORDED WHAT SEEMED A SENSIBLE SOLUTION, AND IN THE PROCESS A DIFFERENT TAX PROBLEM OR AVOIDANCE OPPORTUNITY WAS CONFIRMED OR, WORSE, CREATED.

I. BAILING OUT OF A LEAKY TAX SHELTER AND SIMILAR TRANSACTIONS

A. SECTION 1041

WE DEAL HERE WITH A SIGNIFICANT TAX AVOIDANCE OPPORTUNITY NEWLY CREATED BY THE 1984 LEGISLATION. AN EXAMPLE WILL EXPOSE THE PROBLEM.

EXAMPLE (1). MR. A LOVES HIS WIFE AND HATES HIS TAX SHELTER. THE SHELTER HAS A BASIS IN HIS HANDS OF $1 MILLION, IS WORTH NO MORE THAN THAT, BUT IS ENCUMBERED BY A NONRECOURSE MORTGAGE OF $2 MILLION. MR. A WAS TOLD SOME WHILE AGO THAT ANYTHING HE MIGHT DO WITH THE SHELTER INVESTMENT -- SELL IT, ABANDON IT, GIVE IT AWAY -- WOULD TRIGGER IMMEDIATE TAXABLE GAIN OF $1 MILLION. IT WAS TRUE THEN.[1] HOWEVER, GUIDED BY TAX COUNSEL, MR. A NOW CREATES A TRUST UNDER WHICH ORDINARY INCOME WILL BE DISTRIBUTABLE TO HIS WIFE FOR LIFE, REMAINDER TO THE CHILDREN, AND TO WHICH TRUST MR. A CONTRIBUTES THE SICK TAX SHELTER INVESTMENT AND $100 IN CASH. IN THE FOLLOWING YEAR THE MORTGAGEE FORECLOSES.

IF §1041 HAD NOT BEEN ENACTED, MR. A'S TRANSFER OF THE OVER-MORTGAGED PROPERTY TO THE TRUST WOULD HAVE TRIGGERED IMMEDIATE

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[1] SEE COMMISSIONER v. TUFTS, 103 S. CT. 1826 (1983). IN THE 1984 ACT CONGRESS, CONCERNED BY WHAT APPEARED TO BE A LOOPHOLE IN §751(c), RECONFIRMED (IN SOMEWHAT DIFFERENT FORM) THE TUFTS RESULT BY ENACTING §7701(g).

GAIN TO HIM OF $1 MILLION, TAXED AS ORDINARY INCOME TO THE EXTENT REQUIRED BY THE RECAPTURE RULES, §1250 AND (WHERE APPLICABLE) §1245. SECTION 1041, AWARDING NONRECOGNITION TREATMENT ON A TRANSFER OF PROPERTY TO A SPOUSE (OR A FORMER SPOUSE IF THE TRANSFER IS INCIDENT TO DIVORCE), ALSO AWARDS NONRECOGNITION TREATMENT WHEN THE TRANSFER IS IN TRUST FOR THE BENEFIT OF THAT SPOUSE (OR FORMER SPOUSE). THUS, MR. A'S GIFT IN TRUST OF THE OVER-MORTGAGED PROPERTY IS NO LONGER A TAXABLE EVENT.

THAT WOULD BE A COMPREHENSIBLE RESULT IF THE MATTER WERE IN FACT, AS IT IS IN LAW, ONE OF SOONER OR LATER. THIS WOULD BE THE CASE IF THE FOLLOWING YEAR'S FORECLOSURE ATTRACTED THE APPROPRIATE TAX PAYMENT. BUT IN FACT WILL NOT. SOONER OR LATER HAS BECOME NOW OR NEVER. WHEN THE MORTGAGEE FORECLOSES IN YEAR-2, THE TAXPAYER TO WHICH THE $1 MILLION GAIN IS RECOGNIZED IS THE TRUST. THE TRUST'S ASSETS, POST-FORECLOSURE, ARE LIMITED TO CASH OF ABOUT $100. THE FORECLOSURE GAIN IS NOT CHARGED TO MR. A SINCE HE DOES NOT OWN THIS "CORPUS GAIN," EITHER DIRECTLY OR THROUGH THE GRANTOR TRUST RULES. SIMILARLY, HIS WIFE IS NOT CHARGEABLE WITH THAT GAIN AND THE CHILDREN, MERE REMAINDER PERSONS, CLEARLY HAVE NO TAX LIABILITY. IN SUM, NO ONE WILL PAY THE TAX. INADVERTENTLY, IN 1984 CONGRESS FURNISHED A TAX AVOIDANCE BLUEPRINT FOR THE SUCCESSORS TO MR. TUFTS.

B. SECTION 453B(G)

THE INSTALLMENT METHOD OF REPORTING GAIN ALLOWS THE SELLER, WITH LIMITED EXCEPTIONS, TO DEFER RECOGNITION UNTIL

PAYMENT IS RECEIVED. TO PREVENT DEFLECTION OF THE DEFERRED GAIN TO LESS TAXABLE HANDS, §453B ESTABLISHES AS THE NORMATIVE RULE THAT A DISPOSITION OF THE INSTALLMENT OBLIGATION -- INCLUDING A GIFT -- ACCELERATES GAIN RECOGNITION BY THE TRANSFEROR. NEW §453B(G) AFFORDS AN EXCEPTION: WHEN THE INSTALLMENT OBLIGATION IS TRANSFERRED IN THE MANNER DESCRIBED IN §1041(A), THE TRANSFERRING SELLER DOES NOT RECOGNIZE GAIN AND THE TRANSFEREE OF THE INSTALLMENT OBLIGATION STEPS INTO THE TAX SHOES OF THE TRANSFEROR.

EXAMPLE (2). MR. B HOLDS AT A LOW BASIS AN INSTALLMENT OBLIGATION THAT CALLS FOR A SINGLE LARGE PAYMENT OF PRINCIPAL (LONG-TERM CAPITAL GAIN) TEN YEARS HENCE. C, A RELATED PERSON WHO MAY BE AN INDIVIDUAL OR AN ENTITY, HAS A SUBSTANTIAL CAPITAL LOSS CARRYFORWARD. MR. B TRANSFERS THE INSTALLMENT OBLIGATION IN TRUST FOR THE BENEFIT OF HIS WIFE FOR LIFE (OR PERHAPS FOR A TERM OF 10 YEARS[2]), REMAINDER TO C. IF MR. B'S WIFE DIES IN YEAR-10 (OR IF HER INTEREST IS SIMPLY A 10-YEAR TERM) AND THE TRUST, WINDING UP, PROMPTLY DISTRIBUTES TO C EITHER THE INSTALLMENT OBLIGATION OR THE PROCEEDS OF COLLECTION, THE INSTALLMENT GAIN WILL BE INCLUDED IN C'S TAX RETURN[3] AND C'S CAPITAL LOSS CARRYOVER CAN BE USED TO OFFSET THAT GAIN.

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[2] IT MAY NOT BE ENTIRELY CLEAR, BUT IT WOULD APPEAR THAT A TRANSFER IN TRUST FOR THE BENEFIT OF THE SPOUSE FOR A TERM OF TEN TEN YEARS WILL QUALIFY AS A TRANSFER DESCRIBED IN §1041(A).

[3] IF IN YEAR-10 THE TRUST RECEIVES PAYMENT ON THE NOTE AND DISTRIBUTES ALL TRUST PROPERTY TO C, THE REMAINDER PERSON, THE INSTALLMENT GAIN WILL BE INCLUDED IN DISTRIBUTABLE NET INCOME UNDER §643(A)(3) AND THUS WILL BE TAXED TO C AND NOT TO THE TRUST.

As example (2) confirms, new §453B(g) provides a tax planning opportunity Congress could hardly have intended.

C. Suggested Solution

The 1984 Act "Bluebook"[4] announces that Congress intended no gain be recognized on the transfer of property for the assumption of (or subject to) liabilities in excess of basis, under §1041, only if the spouse (and not a trust) owns the property after the transfer is made. The statute, however, does not comport with that announcement; a technical correction is needed and ought to encompass both §1041 and §453B(g).

An efficient approach would concentrate on §1041(a), since §453B(g) has reference to transactions described in it, and would provide that the general rule of nonrecognition will not apply to a transfer of property in trust if and to the extent the transferor would have recognized gain on such transfer had §1041(a) not been enacted.

II. Partners, Partnerships, and Guaranteed Payments

In the 1984 Act Congress rationalized §707(a), dealing with certain transactions between a partnership and a partner who does not act in that capacity; amended §267(a)(2) to place accrual method taxpayers on the cash method for certain dealings with related cash method taxpayers; and added §267(e) to apply that

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[4] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Joint Committee Print), at 711 n. 10 (December 31, 1984).

MATCHING RULE TO TRANSACTIONS BETWEEN A PARTNERSHIP AND A PARTNER (ACTUAL OR CONSTRUCTIVE PARTNER). CONGRESS DID NOT AMEND §707(c) WHICH, FOR "GUARANTEED PAYMENT" ARRANGEMENTS BETWEEN AN ACCRUAL METHOD PARTNERSHIP AND A CASH METHOD PARTNER, DEFERS TO THE PARTNERSHIP'S METHOD OF ACCOUNTING AND PLACES THE PARTNER ON THE ACCRUAL METHOD. INDEED, SENSITIVE TO THE INCONSISTENCY OF ACCOUNTING TREATMENT, IN §267(E)(4) CONGRESS SUBORDINATED THE CASH METHOD RULE OF §267 TO THE PARTNERSHIP'S METHOD OF ACCOUNTING RULE OF §707(c).

THAT DETERMINATION, WHILE COMPREHENSIBLE IN OTHER RESPECTS, OPENED THE DOOR TO TAX AVOIDANCE PLANNING OF A WELL UNDERSTOOD, AND HERETOFORE DISCREDITED, SORT. SEE, E.G., JEAN V. KRESSER, 54 T.C. 1621 (1970).

EXAMPLE (3). MR. A AND MS. B, UNRELATED INDIVIDUALS, EACH INVESTS $10,000 TO CREATE THE AB PARTNERSHIP IN WHICH EACH HOLDS A 50% INTEREST IN CAPITAL, PROFITS, AND LOSSES. MR. A ALSO LOANS THE AB PARTNERSHIP $100,000 FOR WHICH HE IS TO RECEIVE ANNUAL INTEREST OF $12,000. MS. B ALSO TRANSFERS $100,000 TO THE AB PARTNERSHIP AND RECEIVES IN EXCHANGE A "SENIOR PARTNERSHIP INTEREST" WHICH ENTITLES HER TO RECEIVE, EACH YEAR, A "GUARANTEED PAYMENT" OF $12,000 WHETHER OR NOT THE PARTNERSHIP HAS INCOME. AFTER A COUPLE OF YEARS OF NORMAL PARTNERSHIP OPERATIONS, MR. A IN YEAR-3 ANNOUNCES HE CAN MAKE GOOD USE OF AN EXTRA DEDUCTION AND MS. B ANNOUNCES SHE HAS EXCESS DEDUCTIONS FROM OTHER SOURCES AND CAN ABSORB MORE THAN HER NORMAL SHARE OF INCOME. THE PARTIES agree to create a deduction for Mr. A in year-3 and to reverse the deduction allocation in year-4.

If Mr. A and Ms. B are cash method taxpayers and the AB partnership is on the accrual method, the 1984 Act provides a simple path for achieving the inappropriate goal. In year-3 the AB partnership will not pay Mr. A the $12,000 interest on his loan to the partnership and will not pay Ms. B her $12,000 guaranteed payment. In year-4, the AB partnership will double-up, paying Mr. A year-3 and year-4 interest totalling $24,000 and paying Ms. B year-3 and year-4 guaranteed payments totalling $24,000.

In year-3 cash method Mr. A, receiving no actual payment of interest, has no inclusion in income; the AB partnership under §267(a)(2) is denied a year-3 deduction for the interest it did not pay Mr. A. On the other hand, under §707(c) in year-3 Ms. B is charged $12,000 of income and the AB partnership is awarded a $12,000 deduction with respect to the guaranteed payment it did not make to her. Fifty percent of that $12,000 deduction, or $6,000, is allocated to Mr. A, a 50% partner. The other $6,000 deduction is allocated to Ms. B who, in the result, in year-3 must take into income a net of $6,000 (guaranteed payment income of $12,000 less allocated deduction of $6,000).

In year-4 the AB partnership is allowed an interest deduction of $24,000 and a guaranteed payment deduction of $12,000, for a total of $36,000. One-half of that total deduction, $18,000, is allocated to Mr. A who, charged with interest income of $24,000, has net year-4 income of $6,000. Ms. B, allocated a deduction of $18,000, has guaranteed payment income of $12,000 and thus, in year-4, a net deduction of $6,000.

Example (3) is extremely simple -- in real life the ingenuity of the tax bar will produce more exciting illustrations -- but ought to make the point clearly enough. With the 1984 amendments to §267, converting that provision from a disallowance rule to a deferral rule and extending the reach of that provision to partnerships and partners, there appears to be no good reason to maintain §707(c) separate and apart, and governed by quite different rules, from §707(a). To the contrary, there appear to be good reasons to embrace the opposite approach, expunge §267(e)(4), and subsume §707(c) within or subordinate it to §707(a).

III. Disparate Definitions of "Control"

In the 1984 Act Congress changed in a major way the "affiliated group" definition in §1504(a), and enacted in §368(c)(2) a definition of "control" that applies exclusively to non-devisive "D" reorganizations (§368(a)(1)(D)). These were unrelated amendments. The §1504(a) and §368(c)(2) definitions are significantly different and, while that need not have been so, in view of the very different purposes the provisions serve their differences in definition, grounded in history, are supportable.

But both of these new definitions present important problems that were not ideally handled in the 1984 legislation.

A. §338(d)(3): Qualified Stock Purchase

The Technical Corrections Bill rightly perceives the potential of major tax avoidance planning that resides in the differing affiliation (or control) definitions in §1504(a), on the one hand, and in §§332(b)(1) and 337(c)(2)&(3) on the other hand. The decision to conform these subchapter C provisions to §1504(a) is sensible.

Unaccountably, however, as introduced the Technical Corrections Bill does not propose an equivalent change in §338(d)(3), the definition of a qualified stock purchase. That omission should be corrected. However, because taxpayers almost certainly have relied on the qualified stock purchase definition that currently appears in §338(d)(3), the change ought to be prospective only and transactions, subsequently completed, that are carried out pursuant to a binding contract[5] ought to be governed by current law.

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[5] The term "binding contract" can refer to a contract binding on both parties, binding on the purchasing corporation (even if not binding on the target corporation's shareholders), or binding on all (or the controlling) shareholders of the target corporation even if not binding on the purchasing corporation (i.e., a purchase option). Either the statute or its legislative history ought to make clear which definition Congress has selected.

B. "D" Reorganization vs. A §304 Transaction

Section 304 is the stock acquisition analogue of the non-devisive "D" reorganization asset acquisition. Prior to the 1984 Act the stock acquisition rules and asset acquisition rules were senselessly disparate. The important purpose of enacting §368(c)(2) was to bring the two sets of rules more closely into harmony. The 1984 legislation advanced that goal, but major differences persist. A technical corrections bill is not the appropriate vehicle in which to address many of those differences, but it is the appropriate legislation through which to address the largest of them, one newly created in the 1984 Act.[6]

Example (4). T corporation, worth $1 million, is owned 20% by Mr. A, 20% by Ms. B, and 60% by Mr. C, all of them unrelated individuals. P corporation, a larger enterprise, is owned 25% by Mr. A, 25% by Ms. B, and 50% by X corporation, a public company in which none of the named individuals is a shareholder. For $1 million in cash, P corporation wishes to acquire the business and assets of T corporation. To that end, P will either purchase all of T's stock and file a §338 election, or T will adopt a plan of liquidation and P promptly will purchase all of the assets (and assume the liabilities) of T.

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[6] Differences that cannot fairly be addressed in a technical corrections bill include amount and source of earnings and profits (when the transaction gives rise to a dividend), and the gain limitation (applicable in asset acquisitions but not stock acquisitions).

If P purchases the stock of T, the selling shareholders will enjoy capital gain treatment and a valid §338 election can be filed by P. Those favorable results obtain because the stock purchase transaction is not governed by §304: although Mr. A and Ms. B together own 50% of P and thus are in "control" of P within the "50% of voting power or value" definition contained in §304(c), owning only 40% of T they were not in "control" of T. Section 304 is not applicable to a stock purchase transaction unless one or more persons are in 50% control of both P and T.

If, however, the transaction is carried out as an asset acquisition, a quite different tax result is reached. New §368(c)(2) defines "control" in terms of the 50% test of §304(c), but the definition has relevance only with respect to the ownership of P, the acquiring corporation. The operative reorganization definition, contained in §368(a)(1)(D), is satisfied if persons -- here Mr. A and Ms. B -- in 50% "control" of P were shareholders of T corporation even though they were not controlling shareholders of T.[7]

As example (4) illustrates, current law is a trap for the unwary. At the least, this aspect of the stock acquisition and asset acquisition rules ought to be harmonized. Since a change in §304 would hardly appear a "technical" correction, the 1984 legislative error having been made in §368(c)(2), appropriately the correction should be to the asset acquisition rule. To that end, a sentence might be added to new §368(c)(2) specifying that its special rule shall apply only if those T shareholders (including former T shareholders) who are shareholders (actually or constructively) in 50% control of P also are (or were) in 50% control of T.[8]

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[7] Section 368(a)(1)(D), as well as new §368(c)(2), states that the asset acquisition must meet the requirements of subparagraphs (A) and (B) of §354(b)(1). Facially, a simple cash purchase transaction would not appear to meet those requirements; however, when the corporate assets transferred have included substantially all the operating assets of the transferor corporation, the courts in general have disregarded the statutory detail and held the requirements of §354(b)(1) met.

IV. Closing the Loophole in §311(d)

For in-kind corporate distributions of appreciated property, in the 1984 Act Congress struck a significant blow for tax rationality and simplification. It revised §311(d), applicable to property distributions by an ongoing corporation to its shareholders, to make gain recognition by the distributing company

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[8] Although this solution will bring the stock acquisition and asset acquisition rules into closer harmony, it will not produce a perfect match. As an instance, if in example (4) Mr. A and Ms. B were related persons within the meaning of §318(a)(1), the stock acquisition transaction would not fall under §304 but P's acquisition of their 40% of the T stock would be disqualified as a "purchase" of that stock under §338(h)(3)(A)(iii). A §338 election thus would not be available. If the suggested change in §368(c)(2) is made, the asset acquisition transaction could yield a purchase price basis for P and a liquidation comporting with §337 for T, an overall tax result superior to that obtained in the stock acquisition transaction. It is not at all clear this will be so, however, since the Commissioner might well argue for a less favorable result under Rev. Rul. 61-156, 1961-2 C.B. 62. See, in this regard, the discussion in the "Bluebook," supra n. 4, at 194.

THE NORMATIVE RULE. A WELCOME IF LIMITED REVERSAL OF THE GENERAL UTILITIES DOCTRINE.[9] UNFORTUNATELY, THE DIRECTIVE OF AMENDED §311(D) CAN BE AVOIDED, IT WOULD SEEM, BY WELL ADVISED TAXPAYERS. HERE IS THE LOOPHOLE THAT MERITS SWIFT CLOSING.

EXAMPLE (5). MR. A AND HIS FAMILY OWN ALL THE STOCK OF T CORPORATION. T OPERATES A SUCCESSFUL BUSINESS AND, IN ADDITION, HOLDS A VALUABLE PORTFOLIO OF HIGHLY APPRECIATED MARKETABLE SECURITIES. MR. A'S DAUGHTER, D, WISHES TO DISPOSE OF HER T SHARES AND SEVER ALL CONNECTION WITH THE BUSINESS, AND WOULD BE QUITE HAPPY TO SWAP HER T SHARES FOR T'S PORTFOLIO OF MARKETABLE SECURITIES.

IF THAT TRANSACTION WERE CARRIED OUT IN THE UNCOMPLICATED WAY OF A SIMPLE EXCHANGE, UNDER §311(D)(1) T WOULD RECOGNIZE GAIN EQUAL TO THE APPRECIATION IN THE MARKETABLE SECURITIES. HEEDING BETTER ADVICE, T TRANSFERS ALL OF ITS ASSETS OTHER THAN THE MARKETABLE SECURITIES PORTFOLIO TO NEWCO, A NEWLY ORGANIZED CORPORATION, RECEIVING IN EXCHANGE MOST OF THE STOCK OF NEWCO (THE BALANCE OF NEWCO'S STOCK IS ISSUED FOR CASH TO OTHER MEMBERS OF THE A FAMILY, OR TO EMPLOYEES OR OUTSIDE INVESTORS OR SOME MIXTURE, AS TAX COUNSEL RECOMMENDS). T PROMPTLY LIQUIDATES, DISTRIBUTING THE MARKETABLE SECURITIES PORTFOLIO TO D AND THE NEWCO STOCK TO T'S OTHER SHAREHOLDERS.

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[9] GENERAL UTILITIES & OPERATING CO. v. HELVERING, 296 U.S. 200 (1935).

The transaction qualifies as a reorganization under §368(a)-(1)(D). Newco will inherit T's operating assets at a carryover basis, §362, T will not recognize gain on receipt of Newco shares in exchange for the operating assets transferred, §361, and the T shareholders who receive Newco stock in exchange for their T stock will recognize no gain or loss on that exchange, §354. Those are appropriate tax results. D will recognize capital gain on her exchange of T shares for the marketable securities portfolio, §302(b)(3) & (c)(2), and will hold those securities at a fair market value basis. That result is not indispute. What ought to be the subject of attention in the technical corrections bill is this: because T's distribution of the securities portfolio is made in the context of a "reorganization," §311(d)(1) is by its terms inapplicable and T avoids recognizing gain on the appreciation in its securities portfolio.[10]

The tax avoidance problem is not limited to "D" reorganizations. If, for example, D owned 10% of T and the marketable securities portfolio represented 10% of the value of T, an equivalent planning opportunity would arise in the context of a "C"

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[10] In the extreme case posed in example (5), the Commissioner might well argue for "bifurcation" or "severance" -- treating the "D" reorganization and the in-kind redemption of D's shares as "functionally unrelated" and applying to the redemption exchange the recognition rule of §311(d)(1) -- but it is by no means clear the Commissioner would prevail and a good deal less clear that an auditing revenue agent would comprehend either the issue or the argument. And, of course, the greater the differences in the ownership of T before the transaction and the ownership of Newco after it, the less likely it will be the Commissioner can succeed in court.

REORGANIZATION, §368(A)(1)(C). A TRANSFER BY T OF ALL OF ITS OTHER ASSETS TO X CORPORATION, A LARGE PUBLIC COMPANY, IN EXCHANGE FOR X VOTING STOCK, FOLLOWED BY A LIQUIDATION OF T IN WHICH T'S SECURITIES PORTFOLIO IS DISTRIBUTED TO D AND THE X STOCK IS DISTRIBUTED TO ALL OF THE OTHER T SHAREHOLDERS, IS THE CASE IN POINT. UNDER THE TAX LAW AS AMENDED IN 1984, IT IS CLEAR THAT T WILL NOT RECOGNIZE GAIN ON THE APPRECIATION IN THE MARKETABLE SECURITIES PORTFOLIO.

THIS IS A WRONG ANSWER FOR A REASON EASILY COMPREHENDED. CURRENT TAX LAW RESERVES NONRECOGNITION TREATMENT, WHEN CORPORATE ASSETS ARE AWARDED A FAIR MARKET VALUE BASIS, FOR TRANSFERS AND DISTRIBUTIONS MADE IN THE COURSE OF A COMPLETE LIQUIDATION. SECTIONS 336 AND 337 ANNOUNCE THAT RULE. IT IS, ON THE OTHER HAND, BASIC TO THE DEFINITION OF A CORPORATE REORGANIZATION THAT THE BUSINESS ENTERPRISE IS CONTINUING IN MODIFIED CORPORATE FORM AND, AS A GROUP, THE SHAREHOLDERS ARE MAINTAINING A SIGNIFICANT CONTINUITY OF THEIR EQUITY INTEREST IN THE CORPORATE ENTERPRISE. THE "LIQUIDATION" OF T, INCIDENT TO A "C" OR "D" REORGANIZATION, IS NOT THE "COMPLETE LIQUIDATION" THAT §§336 AND 337 REASONABLY CONTEMPLATE.[11]

SECTION 311(D) SHOULD BE AMENDED TO CONFIRM ITS APPLICABILITY TO A DISTRIBUTION OF RETAINED ASSETS INCIDENT TO A REORGANIZATION IN WHICH THE CORPORATION IS THE ACQUIRED OR TRANSFEROR CORPORATION.

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[11] THIS MATTER IS THE SUBJECT OF A FURTHER, RELATED ANALYSIS AND RECOMMENDATION IN PART V OF THIS PAPER.

V. SECTION 368(A)(2)(G): THE MINNESOTA TEA CO. PROBLEM

FOR MORE THAN 60 YEARS THE TAX LAW HAS ASSURED US THAT A TARGET CORPORATION, TRANSFERRING PROPERTY IN A REORGANIZATION AND RECEIVING IN EXCHANGE SHARES (AND PERHAPS OTHER, "BOOT" PROPERTY) OF THE ACQUIRING CORPORATION, WILL NOT RECOGNIZE GAIN IF AND WHEN IT REDISTRIBUTES IN PURSUANCE OF THE PLAN OF REORGANIZATION. THE CURRENT EMBODIMENT OF THAT RULE IS §362. IT IS THE DOCTRINE OF THE MINNESOTA TEA COMPANY CASE[12] THAT, TO QUALIFY AS A DISTRIBUTION "IN PURSUANCE OF THE PLAN OF REORGANIZATION," THE DISTRIBUTION MUST BE TO A SHAREHOLDER (OF THE DISTRIBUTING CORPORATION) IN HIS SHAREHOLDER CAPACITY. DISTRIBUTION TO A CREDITOR, OR EVEN DISTRIBUTION TO A SHAREHOLDER WHO ASSUMES THE OBLIGATION TO PAY A CREDITOR, IS NOT A DISTRIBUTION "IN PURSUANCE OF THE PLAN OF REORGANIZATION" UNDER MINNESOTA TEA COMPANY.

IN THE PAST, THE MINNESOTA TEA COMPANY DOCTRINE HAS BEEN OF LIMITED PRACTICAL CONCERN. IN THE UNUSUAL FACTUAL CASE IN WHICH IT MIGHT BE FOUND APPLICABLE, IT COULD REQUIRE LIMITED GAIN RECOGNITION BY T, THE TARGET CORPORATION IN THE REORGANIZATION, BUT WOULD NOT OTHERWISE AFFECT THE TAX TREATMENT OF THE ARRANGEMENT. AS A RESULT OF AN INADVERTENT TECHNICAL ERROR IN THE 1984 ACT, HOWEVER, A CONCERN OF FAR GREATER MAGNITUDE HAS SURFACED.

EXAMPLE (6). T CORPORATION TRANSFERS SUBSTANTIALLY ALL OF ITS ASSETS TO UNRELATED P CORPORATION. P ASSUMES SUBSTANTIALLY

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[12] MINNESOTA TEA CO. V. HELVERING, 302 U.S. 609 (1939).

ALL OF T'S LIABILITIES AND ISSUES TO T SHARES OF P VOTING STOCK. THE TRANSACTION IS INTENDED TO QUALIFY AS A "C" REORGANIZATION, §368(A)(1)(C), AND TO GAIN THAT TAX TREATMENT T MUST, UNDER 1984 ENACTED §368(A)(2)(G), DISTRIBUTE THE P STOCK IT HAS RECEIVED, TOGETHER WITH ANY ASSETS T HAS RETAINED, "IN PURSUANCE OF THE PLAN OF REORGANIZATION."

IF P HAS ASSUMED ALL OF THE LIABILITIES OF T, SO THAT T CAN DISTRIBUTE SOLELY TO ITS HISTORIC SHAREHOLDERS, THERE WILL BE NO DIFFICULTY IN MEETING THE REQUIREMENTS OF NEW §368(A)(2)(G). BUT TOO OFTEN THIS MAY NOT BE THE CASE.

ASSUME Y HAS ACTED AS INVESTMENT BANKER AND Z AS SPECIAL COUNSEL TO T IN THE TRANSACTION, AND THAT P HAS NOT ASSUMED T'S OBLIGATION TO COMPENSATE Y AND Z. FOR THAT REASON T HAS RETAINED CASH EQUAL TO, SAY, 2% OF ITS NET WORTH (AND AS A RESULT HAS RECEIVED FEWER P SHARES IN THE TRANSACTION). T USES ITS RETAINED CASH TO PAY Y AND Z. IN ADDITION, BECAUSE THE CLAIMS OF THESE CREDITORS EXCEED THE RETAINED CASH, T TRANSFERS TO Y 100 P SHARES (WORTH $10,000) THAT T HAS RECEIVED IN THE TRANSACTION. T THEN DISTRIBUTES THE BALANCE OF THE P SHARES TO T'S HISTORIC SHAREHOLDERS.

HAS T DISTRIBUTED ALL OF THE P SHARES, AND ALL OF T'S RETAINED ASSETS, "IN PURSUANCE OF THE PLAN OF REORGANIZATION"? UNDER MINNESOTA TEA COMPANY, RATHER CLEARLY IT HAS NOT. UNDER NEWLY ENACTED §368(A)(2)(G), UNLESS TREASURY PROMPTLY PROMULGATES A

SAVING REGULATION THE TRANSACTION WILL FAIL TO MEET THE REQUIREMENTS OF A "C" REORGANIZATION AND THUS IS CONVERTED TO AN EXCHANGE TAXABLE TO T (SUBJECT TO THE NONRECOGNITION BENEFITS OF §337) AND TO T'S SHAREHOLDERS AS WELL.[13]

OBVIOUSLY, IN 1984 CONGRESS MERELY INTENDED TO IMPOSE ON TRANSFEROR CORPORATIONS IN "C" REORGANIZATIONS THE REQUIREMENT OF LIQUIDATION. CONGRESS DID NOT INTEND TO REPEAL THE "C" REORGANIZATION FOR CASES IN WHICH THE ILL ADVISED TRANSFEROR CORPORATION COMMITS A MINOR FOOTFAULT.

THE PROBLEM CAN OF COURSE BE ADDRESSED THROUGH A SIMPLE CLARIFYING AMENDMENT TO NEW §368(A)(2)(G), IN EFFECT STATING THAT FOR PURPOSES OF THIS PROVISION MINNESOTA TEA COMPANY IS OVERTURNED. BUT A VERY NARROW APPROACH OF THIS SORT WOULD BE UNFORTUNATE, FOR IT WOULD LEAVE ELSEWHERE IN PLACE THE MINNESOTA TEA COMPANY DOCTRINE AND, WITH IT, A SUBSTANTIAL AMOUNT OF CONFUSION THAT HAS DEVELOPED IN THE TAX LAW OVER THE PAST DECADE.

THE PROBLEM IS ILLUSTRATED, IN EXAMPLE (6), BY T'S TRANSFER TO CREDITOR Y OF P SHARES, RECEIVED IN THE "C" REORGANIZATION EXCHANGE, WORTH $10,000 AND HAVING, LET US ASSUME, A SUBSTITUTED BASIS IN T'S HANDS OF $4,000. THE MINNESOTA TEA COMPANY DOCTRINE suggests that T must recognize gain of \$6,000 on that distribution to creditor Y. Good sense urges that T should not recognize gain since, had P assumed the liability to Y (therefore issuing \$10,000 less P shares to T) and had P then discharged the liability by delivering \$10,000 worth of P shares to Y, neither T nor P would have recognized gain (§1032).

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[13] THE TREASURY'S POWER TO PROMULGATE A SAVING REGULATION IS CONFIRMED BY §368(A)(2)(G)(II), AND THE NEED FOR A PROMPT REGULATION IN THE ABSENCE OF A STATUTORY CORRECTION IS APPARENT. IF THE TRANSACTION IS A TAXABLE EXCHANGE, NOT A REORGANIZATION, P WILL NOT RECOGNIZE GAIN, §1032, BUT P WILL OBTAIN THE T ASSETS AT A FULL PURCHASE PRICE BASIS (RATHER THAN THE LOWER CARRYOVER BASIS THAT OBTAINS IN A REORGANIZATION).

Under current law T, distributing P shares to Y, avoids recognizing the \$6,000 gain if §337 is held to apply to a "sale" of appreciated property (the P shares) made in the course of T's liquidation in pursuance of the plan of reorganization. Technically, the question is whether liquidation in pursuance of a plan of reorganization is a "complete liquidation" within the contemplation of §337. For the reasons explored in part IV of this paper, the answer to that question should be "no." But under the current statute "no" requires that T recognize, with respect to the P shares, a gain that ought not be recognized.

The courts on two occasions have addressed this specific question, in the reorganization context, and have reached conflicting conclusions. In FEC Liquidating Corp. v. United States, 548 F.2d 924 (Ct. Cl. 1977), §337 was held inapplicable on the ground of no "complete liquidation." In General Housewares, Inc. v. United States, 615 F.2d 1056 (5th Cir. 1980), a "complete liquidation" was found and §337 was held to apply. The latter decision has been rightly criticized because it opens the door to substantial tax avoidance when the property, transferred to the creditor, is not P shares received in the reorganization but is instead appreciated property retained by T out of the reorganization.

The problem of a disqualified reorganization created by §368(a)(2)(G), the opportunity to end-run amended §311(d) that is outlined in Part IV of this paper, and the confusion illustrated by FEC Liquidating and General Housewares, all can be sensibly addressed through a Technical Corrections Act confirmation that (1) Minnesota Tea Company is overturned, and (2) a liquidation in pursuance of a plan of reorganization is not a "complete liquidation" to which §337 applies.

In 1984 the Section of Taxation of the American Bar Association adopted a Legislative Recommendation (No. 1984-5) to reach these sensible results. The Legislative Recommendation was prepared before the enactment of §368(a)(2)(G), but the technical changes it proposes in §361(b) would subsume the necessary correction of §368(a)(2)(G). Adoption of the Tax Section's Legislative Recommendation as part of the Technical Corrections Act of 1985 would resolve, in a sensible and coordinate way, a series of technical problems that did not originate with, but without doubt were exacerbated by, the 1984 Act.[14]

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[14] Copies of Legislative Recommendation 1984-5 were delivered in 1984 to the Committee and the staff, and additional copies currently are being made available by the Section of Taxation.

STATEMENT OF MAC ASBILL, JR., SUTHERLAND, ASBILL & BRENNAN, WASHINGTON, DC

Mr. ASBILL. Thank you, Mr. Chairman. When I see myself on this distinguished panel, I feel a little bit like the Missouri mule that entered the Kentucky Derby. He told his friends he really didn't think he would win, but he felt the association might do him a lot of good. [Laughter.]

I have a problem here with an effective date provision that was added by the Technical Corrections Act. DEFRA, as you may know, added a section to the Code, 312(n)(8), that changed the rules for the adjustment of earnings and profits resulting from certain stock redemptions. DEFRA left blank the effective date of that provision. The Technical Corrections Act, I think wrongly, puts it in as the date of enactment of DEFRA. I think it should be a later date for reasons that I will describe very briefly.

I am interested in this because it impacts a client of mine, a small, closely-held corporation in California, which contemplated, beginning in 1983 before DEFRA was conceived, a redemption under Section 303 of one of its principal stockholders who was then ill. They wanted to follow that redemption by liquidation under 333. They completed the redemption on September 20, 1984, which was during the corporation's 1984 fiscal year, ending October 31, and the liquidation occurred in December of 1984. Now, Howard Rose and its attorneys were led to believe by the legislative history of DEFRA that Section 312(n)(8) would not be applicable to this redemption which occurred in the taxable year beginning before the date of enactment of that Act. They were led to believe that because the Senate provision in DEFRA had an effective date which covered taxable years beginning after date of enactment, and the conference report indicated it would go along with the Senate, with only one change—i.e. to push back or delay that effective date to taxable years beginning after September 30. Nevertheless, as I indicated, the date in the final bill was left blank. The Technical Corrections Act has said it ought to be the date of enactment. Now, application of that effective date provision to the transaction I have described increases the ordinary income arising from the liquidation of corporation from about $220,000 to $388,000. That is an increase of 75 percent, and it generates unanticipated tax liability of about $80,000.

I think the effective date that is now in the Act is unfair and unwarranted as applied to a taxpayer like Howard Rose, which began legitimate tax planning before any version of DEFRA was released, and where the subsequent legislative history of DEFRA indicated that the Act would not impact that planning adversely. Consequently, I respectfully urge the committee to amend Section 104(e)(3) of the Technical Corrections Act to correct this.

The CHAIRMAN. Thank you.

[The prepared written statements of Mr. Asbill and Mr. Valentine follow:]

Statement of

Mac Asbill, Jr.
Sutherland, Asbill & Brennan
1666 K Street, N.W.
Washington, D.C. 20006
(202) 872-7813

on behalf of

HOWARD ROSE COMPANY

Before the
Senate Committee on Finance

June 5, 1985

I.

INTRODUCTION

I appear today as counsel for Howard Rose Company ("HRC"), a small, privately held California corporation which has an October 31 taxable year. In September, 1984, its 1984 fiscal year, HRC redeemed a portion of its stock pursuant to section 303 of the Internal Revenue Code of 1954, as amended (the "Code"). In December, 1984, HRC was liquidated pursuant to section 333 of the Code. HRC and its attorneys believed justifiably that the effect of the redemption on earnings and profits would be governed by pre-DEFRA law. That expectation will be frustrated if the effective date now contained in S. 814, the Technical Corrections Act of 1985, is not changed.

Section 312(n)(8) of the Code, which was added by the Deficit Reduction Act of 1984, changed the manner in which earnings and profits are to be reduced upon a redemption by a corporation of its stock in a transaction, such as one under section

303, that is treated as a sale or exchange of the stock. Under prior law, upon such a redemption by a corporation of its stock, earnings and profits were reduced by an amount equal to the excess of the amount of the distribution over the amount properly chargeable to the corporation's capital account. Under section 312(n)(8), earnings and profits are to be reduced by the same fraction of the distribution as the amount of stock that is redeemed bears to the total stock outstanding before the redemption.

Although Congress inadvertently failed to specifically provide an effective date for section 312(n)(8), the legislative history of this provision indicated that Congress intended section 312(n)(8) to be effective with respect to redemptions in taxable years beginning after the date of enactment, i.e., in HRC's case, its 1985 fiscal year. However, section 104(e)(3) of S. 814, the Technical Corrections Act of 1985, provides, I believe erroneously, that section 312(n)(8) (renumbered as section 312(n)(7) by the Act), is effective for redemptions after July 18, 1984, in taxable years ending after such date.

Adoption of that effective date would make the new provision applicable to the section 303 redemption that occurred in HRC's 1984 fiscal year, thereby increasing the amount of earnings and profits treated as a dividend upon the subsequent section 333 liquidation from approximately $220,000 to $388,000, an increase of over 75 percent, and increasing by about $80,000 the tax liability of HRC's shareholders upon that liquidation.

II.

TRANSACTION INVOLVED

Mr. Charles Howard, Sr., a principal stockholder of the Howard Rose Company, died on January 3, 1984. He had been in poor health for some time before his death, and during that period his attorneys had discussed with him and with Charles, Jr., who was to be his executor, the desirability of utilizing a section 303 redemption to provide funds for payment of death taxes. It was also thought that a redemption based, as this one would be, upon an arms-length evaluation, would assist in fixing the value for estate tax purposes of that portion of Mr. Howard Sr.'s stock that was not redeemed. Within a month of Mr. Howard's death, the subject of a section 303 redemption was again raised by the attorneys with the executor of his father's estate. As early as late January or the first half of February, 1984, the attorneys wrote the executor emphasizing the fact that a section 303 redemption permitted the executor to raise money for federal tax purposes without incurring income tax liability to the estate, and also analyzing the effect of such a redemption on earnings and profits. At the same time the subject of an eventual liquidation of the corporation under section 333 was discussed with the executor.

In March of 1984, the Senate version of DEFRA was released. It contained an amendment to section 312 governing adjustments to earnings and profits by reason of redemptions (section 312(n)(8)). There was no comparable provision in the

House bill. The Senate amendment was to be effective with respect to redemptions occuring in taxable years beginning after the effective date of the Act. Since HRC was on an October 31st fiscal year, and since the section 303 redemption would be carried out in its 1984 fiscal year, it seemed clear that the redemption would be governed by existing rules rather than by the Senate provisions. Had it known that there was any thought of moving the effective date of section 312(n)(8) back to the date of enactment of DEFRA, the estate could have expedited the section 303 redemption to a date prior to the date of enactment.

It was not until the enactment of DEFRA in late July, 1984 that the attorneys for HRC became aware of the fact that section 312(n)(8), as enacted, had no specific effective date. They believed that this was an oversight, and their opinion was confirmed by a Prentice-Hall publication (1984 Prentice-Hall Federal Taxes Report Bulletin No. 33, ¶ 60,359 (July 26, 1984)) which stated not only that the provision was effective September 30, 1984, the date to which the Conference Agreement extended other related provisions of the Senate Bill, but also that the error would be corrected in a Technical Corrections Act.

The attorneys accordingly thought that the issue had been resolved and that they could proceed with the assurance that the contemplated redemption would be governed by pre-DEFRA law if it occurred during HRC's 1984 fiscal year. They effectuated the redemption in September, 1984.

It was not until early 1985 that the attorneys were made aware by the Blue Book on DEFRA that the Joint Committee was taking the position that the effective date of section 312 (n)(8) was the date of enactment, or July 18, 1984. By that time the redemption had long since been completed.

Thus, the HRC planning had begun, in reliance on pre-DEFRA law, before any version of DEFRA had seen the light of day. By September 20, the date of the redemption, it appeared that reliance was still justified, notwithstanding the absence in DEFRA of a specific effective date for section 312(n)(8).

III.

LEGISLATIVE HISTORY

Responding to concerns that corporate earnings and profits did not accurately reflect economic income, thus providing unintended tax benefits to shareholders when distributions were made, the Senate Finance Committee proposed several changes to section 312 of the Internal Revenue Code of 1954, as amended. S. 2062, Section 47(d). Six of these provisions, including the provision here involved relating to the effect of redemptions upon corporate earnings and profits, were to be effective with respect to "amounts paid or incurred in, or distributions or redemptions occurring in, taxable years beginning after the date of enactment. . . ." S. 2062, Section 47(d)(1)(A).

The Conference Committee Report indicates that the "conference agreement generally follows the Senate amendment with several modifications." Of the six provisions of the Senate bill providing an effective date with respect to "amounts paid or incurred in, or distributions or redemptions occurring in, taxable years beginning after the date of enactment," five of the provisions were made applicable by the conferees to taxable years beginning after September 30, 1984. The effective date for the sixth provision, section 312(n)(8) relating to redemptions, was inadvertently omitted.

Moreover, with respect to the other four provisions contained in section 47 of S. 2062, the Conference Report extended three of the effective dates to September 30, 1984. (Sections 312(n)(4), 312(n)(6), and 312(n)(7)), and left the fourth unchanged (section 312(a)(2), 312(o)). In other words, in no instance in which a specific effective date was enacted did the Conference Report adopt an effective date _earlier_ than that proposed by the Senate bill, and in all but one case, _extended_ the effective date to September 30, 1984.

When it addressed section 312(n)(8), the specific provision here involved, the Conference Report stated that the "conference agreement is generally the _same as_ the Senate amendment," but failed to specify the effective date of such provision. (Emphasis added.) There was nothing to put taxpayers on notice that this omission reflected a conscious decision by the conferees to make the effective date of section 312(n)(8) the date of enactment of DEFRA. Indeed, where the conferees intended one of the provisions of section 61 of the Deficit Reduction Act relating to earnings and profits to be effective as of the date of enactment, they specifically so provided. Section 61(e)(4) of the Act; Section 301(f) of the Code. Accordingly, it was reasonable to infer from the legislative history, including the Conference Committee's action, as HRC's attorneys and Prentice-Hall did, that Congress inadvertently failed to provide that the provisions of section 312(n)(8) would be effective with respect to redemptions in taxable years beginning after the date of enactment, or perhaps after September 30, 1984.

IV.

CONCLUSION

Section 104(e)(3) of S. 814, the Technical Corrections Act of 1985, provides that the effective date of section 312(n)(8) (renumbered as section 312(n)(7) by the Act) is July 18, 1984. Adoption of that effective date will unfairly frustrate the legitimate expectations of taxpayers such as HRC that were led to believe that the provision would not apply to redemptions in taxable years beginning before the date of enactment. I believe that a technical amendment to section 312(n) (8) is entirely appropriate in light of the failure to specifically provide an effective date for that provision. However, the omission should be corrected by an effective date provision that does not result in the type of unfairness described above.

Statement by

Richard H. Valentine

of Seward & Kissel

on behalf of

Baldwin Securities Corporation

before the

Committee on Finance

U. S. Senate

June 5, 1985

Mr. Chairman, members of the Committee, thank you for this opportunity to present testimony concerning technical corrections to the Tax Reform Act of 1984 (the "Tax Reform Act"). I am Dick Valentine of the New York City law firm of Seward & Kissel and I am testifying today on behalf of Baldwin Securities Corporation ("Baldwin") in favor of a technical amendment to Section 1071 of the Tax Reform Act. Section 1071 removed the prohibition that prevented a personal holding company ("PHC") from being eligible to be taxed as a regulated investment company ("RIC") and made this amendment effective beginning in tax years after December 31, 1982.

Baldwin is a Delaware corporation with its principal place of business in New York City. It has been registered under the Investment Company Act of 1940 as a diversified closed-end management investment company since 1950 and has approximately 3300 shareholders. Over 50% of Baldwin's shares are held by one family, making it a PHC for federal income tax purposes and, therefore, ineligible to be taxed as a RIC before the Tax Reform Act. In order to avoid the penalty tax on PHCs, Baldwin has annually distributed all of its short-term capital gains and income from dividends and interest, exclusive of expenses and taxes, to its shareholders. Baldwin has accumulated its long-term capital gains.

A corporation that has not qualified as a RIC will be taxed at the corporate level on all of its income, including income it distributes to its shareholders. A RIC, on the other hand, is not taxed at the corporate level on income which it distributes to its shareholders. Thus, qualifying as a RIC for income tax purposes is a significant economic benefit.

In order to be eligible to be taxed as a RIC for Federal income tax purposes for a taxable year, a corporation must meet the requirements imposed by Sections 851(a), 851(b) and 852(a) of the Internal Revenue Code of 1954, as amended (the "Code"). Among those requirements are: (1) that the corporation is a registered investment company under the Investment Company Act of 1940; (2) that the corporation file with its Federal income tax return for the taxable year an election to be taxed as a RIC or that such election have been filed for a previous taxable year, and (3) that the corporation distribute for the taxable year 90% of its "investment company taxable income" and 90% of its tax-exempt interest income (the "90% Distribution Test").

A PHC which was a registered investment company under the Investment Company Act of 1940 for its taxable year beginning after December 31, 1982, and which met the other substantive requirements for RIC status for such taxable year, still would not qualify as a RIC unless it made an election to be taxed as a RIC on its Federal income tax return and unless it met the 90%

Distribution Test for such taxable year. Any such corporation which filed its return before July 18, 1984, the date of enactment of the Act (a corporation having a taxable year ending December 31, 1983 would file its tax return by March 15, 1984), could not have made a RIC election on its return because, based on the law which existed at the time the corporation filed its return, a PHC would not qualify as a RIC. Under current law, it is not clear whether an election to be taxed as a RIC could be made by such a corporation on an amended Federal income tax return filed after the date of enactment of the Tax Reform Act.

Furthermore, such a corporation may not be able to meet the 90% Distribution Test since, as a PHC, it probably would have distributed for its taxable year ended prior to the enactment of the Tax Reform Act an amount equal to its "investment company taxable income" less the Federal income taxes attributable thereto.* Such a corporation would be able to meet the 90% Distribution Test if it is permitted to make an additional dividend relating back to such taxable year pursuant to Code Section 855.** However, Code Section 855 requires that the additional dividend be declared prior to the corporation's filing its Federal income tax return for a taxable year (including extensions) and that the corporation elect on its Federal income tax return to have the dividend considered paid during the prior year for purposes of the 90% Distribution Test. If such a corporation had filed its return for a taxable year which began after December 31, 1982 and ended prior to the enactment of the Tax Reform Act it is not clear under current law whether such corporation could qualify as a RIC for 1983 by electing to utilize the Code Section 855 procedure in connection with an amended return filed after the date of enactment of the Tax Reform Act.

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* If Federal income taxes for such taxable year were more than 10% of "investment company taxable income," the 90% Distribution Test would not be met.

** Pursuant to Code Section 855, a RIC is permitted to meet the 90% Distribution Test for a taxable year by paying an additional dividend in the following taxable year provided (i) that the declaration of such additional dividend is made before the due date (including extensions) for filing its tax return for the taxable year and (ii) that an election is made on such tax return designating what portion of such dividend is to be treated as paid in the taxable year.

It is our recommendation that a technical amendment to the Act be adopted as part of H.R.1800 which would expressly permit a PHC which otherwise met the requirements for RIC status with respect to its first taxable year beginning after December 31, 1982 and which had filed its Federal income tax return for such taxable year prior to the enactment of the Tax Reform Act:

(1) to elect to be taxed as a RIC for such taxable year on an amended Federal income tax return filed no later than September 15, 1984, the date to which an automatic extension for filing an income tax return would have been been granted; and

(2) to declare an additional dividend and elect on its amended return pursuant to Code Section 855 to relate that dividend back to such taxable year for purposes of the 90% Distribution Test.

These provisions could be enacted by amending Section 1071(a)(5) of the Tax Reform Act. A proposed amendment is attached to this Statement.

We believe the proposed technical amendment is clearly consistent with the intention of Congress to have the repeal of the PHC prohibition for RICs be effective for taxable years beginning after December 31, 1982. Unless the steps described above could be taken in connection with amended returns the December 31, 1982 effective date set by Congress with respect to the RIC provisions relating to PHC's would be meaningless to certain investment companies which had filed their 1983 return prior to the enactment of the Tax Reform Act.

Our proposed technical amendment eliminates a potential unfairness against certain corporations. For example, Baldwin is a calendar year taxpayer which filed its Federal income tax return for its taxable year ended December 31, 1983 on March 15, 1984. For 1983, Baldwin could have qualified as a RIC but for the fact that it was a PHC. When it filed its return on March 15, 1984 it could not have elected to be taxed as a RIC because the Tax Reform Act was not enacted until July 18, 1984. However, if Baldwin had applied for an automatic extension to file its 1983 Federal income tax return until September 15, 1984, it could have elected to be taxed as a RIC for 1983 and it could have used the Code Section 855 procedure for relating back dividends in order to comply with the 90% Distribution Test merely because the due date of its 1983 Federal income tax return was extended until September 15, 1984. It would appear to us very unfair to penalize a corporation which filed its 1983 Federal income tax return on March 15, 1984 while rewarding a corporation which applied for an extension to file its 1983 Federal income tax return until September 15, 1984.

We do not believe that the proposed amendment will affect other provisions of the Tax Reform Act relating to RICs. The Tax Reform Act, in addition to eliminating the prohibition against PHCs qualifying as RICs, imposed the requirement that a RIC distribute any earnings and profits which it accumulated during those years in which the corporation was not a RIC. The requirement that a RIC distribute its accumulated earnings and profits from non-RIC years does not, however, apply to a corporation which meets all of the other RIC qualification standards for each of its taxable years ending after November 8, 1983. Thus, a calendar year corporation which met the RIC qualification standards for its year ended December 31, 1983, could qualify as a RIC in 1983 and in subsequent years without distributing its accumulated earnings and profits from non-RIC years.

The Tax Reform Act permits certain registered investment companies which could not previously qualify as RICs because they were PHCs and which filed for the automatic extension to September 15, 1984, to file their 1983 tax returns to qualify as RICs for 1983 and for subsequent years without distributing their accumulated earnings and profits. However, a company such as Baldwin which filed a timely 1983 tax return on March 15, 1984 (i.e., before the Tax Reform Act was enacted) and which did not file for the automatic extension to September 15, 1984, might not qualify as a RIC for 1983, and might not be able to qualify as a RIC for subsequent years without distributing its accumulated earnings (consisting of long term capital gains) from non-RIC years.

The rationale for the requirement that a RIC distribute its accumulated earnings and profits from non-RIC years is to prevent certain operating businesses which have accumulated operating profits from being able to sell their operating assets and to then qualify for treatment as RICs without distributing their operating profits. In addition, there was concern that so-called "tax-managed funds" (i.e., investment companies which accumulated large amounts of dividend income without paying corporate tax thereon because of the 85% dividends received deduction) could become RICs without distributing such accumulated dividend income. These concerns do not apply to Baldwin because Baldwin has been a registered investment company since 1950, not an operating company, and has distributed its dividend income every year to avoid the PHC tax penalty. The fact that Baldwin has accumulated long term capital gains should not be relevant because a RIC is permitted under the Code to accumulate long term capital gains without distributing such gains to its shareholders.

We believe there are only a few corporations who face the problem outlined in this statement. The primary reason for this is that there are very few corporations registered under the Investment Company Act of 1940 which are PHC's. It is apparent that Congress intended that such companies be able to qualify as RICs and our proposed technical amendment will carry out this intent. Furthermore, such a technical amendment could avoid unnecessary litigation on this issue.

In conclusion, we believe a technical amendment of the type suggested above clarifies the problem we have raised and promotes the clear intention of the Tax Reform Act provisions relating to repeal of the prohibition on PHC's qualifying as RICs.

Thank you for this opportunity to present our views on S.814. We would be pleased to provide the Committee with any further information it may require to resolve the issues addressed in our Statement.

The CHAIRMAN. All right. I want to ask you one question, if I might, Mr. Asbill. As a matter of general statutory construction where there is no effective date, as you are well aware, the effective date is the date of passage. Why are you suggesting we should change that here?

Mr. ASBILL. I think, as my statement indicates, Mr. Chairman, the legislative history led anybody who looked at it objectively to believe that the effective date of this provision was going to be for taxable years beginning sometime after the date of enactment. That is what the Senate did, and the conference report indicated they were not trying to change that. Also, I might add that in other provisions in DEFRA relating to earnings and profits, where the intention was to make it effective on the date of enactment, that was so stated. So, the whole history of this thing would lead somebody to believe that the rules were not going to be changed for transactions already in progress. That is what our people led them to believe. Prentiss-Hall led them to believe that, and put out a public release to that effect and said it would be corrected in the Technical Corrections Act. The only problem is they corrected it, I believe, the wrong way.

The CHAIRMAN. That is a very frank answer. Senator Baucus?

Senator BAUCUS. I understand from what you said that you want to create an exception to the rule. Is that correct?

Mr. MACLEAN. Not create an exception. There already is an exception in the law for those companies who invest directly with foreign banks to receive interest up to a working capital amount. The present law provides for 10 percent of their revenues from foreign sources. We find that terribly unfair because it puts us at a competitive disadvantage, vis-a-vis foreign banks who can sell their deposits directly to U.S. companies. We are money managers. We run a money market mutual fund in particular that invests in foreign money market securities which provide interest. Essentially, the same kind of securities that a company might invest in directly, but if a U.S. company chose to use our services as a money manager because we provide professional management, liquidity, diversification, or perhaps even a better yield on occasion, the company could not obtain the same benefits it would have if it invested a foreign bank, as the law is now written. We have a transition period that runs out on June 30, and it leaves our customers in a limbo status, and the only clear, safe way to continue to invest their working capital would be directly with a foreign bank. We think that is a ridiculous conclusion and was not the intent. What we would like to have is a working capital exception that applied both for direct investment and indirect investment for mutual funds such as ours.

Senator BAUCUS. What effect would that have on our balance of payments?

Mr. MACLEAN. I would think it would only be favorable in the sense that a mutual fund is a means for people to collectively invest their assets. In this case, you would find that smaller businesses and medium sized businesses engaged in foreign trade might find it advantageous to invest with us—have us make investment selections—for the reasons I just gave—diversification, liquidity, and perhaps higher yield. And as a result of that, it would aid their operations abroad and would encourage foreign trade and I believe enhance our balance of payments in the long run.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. I have no questions of these witnesses, Mr. Chairman, but I will have with the next panel.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Mr. Chairman, I think we are going to be in a quandry here. Each of these sounds so appealing as they come forward. Mr. Asbill, on the question that the chairman asked you, normally any legislation we pass would be effective on the date of passage. Right?

Mr. ASBILL. That is the general rule, if no other date is stated. Yes, sir.

Senator CHAFEE. And what you are saying is what? What are you hanging your hat on to choose the beginning of 1985 as the effective date?

Mr. ASBILL. Why am I hanging my hat on what?

Senator CHAFEE. What are you hanging your hat on to have a date other than the date of passage?

Mr ASBILL. I am hanging it primarily, Senator, on the legislative history which indicated and led people honestly to believe that the effective date of this provision was going to be a prospective date, that is, taxable years beginning after the date of enactment. I think the general rule that the date of enactment is the effective date is all right if you don't have any other history to indicate that some other date was intended or would be provided. But here, we have a situation where the drafters have thought it desirable or necessary to come in with a specific date in the Technical Corrections Act, that is, not just leave the blank the way it was in DEFRA. My point is that I think they have come in with the wrong date because they have moved it substantially backward from where people were entitled to believe it would be.

Senator CHAFEE. And you would think it would be applied to the taxable year beginning after the date of enactment?

Mr. ASBILL. I think that would be a satisfactory solution. Yes, sir.

Senator CHAFEE. January 1, 1985?

Mr. ASBILL. It depends upon what taxable year the taxpayer is on.

Senator CHAFEE. Yes. Your fellow was on the calendar year, wasn't he?

Mr. ASBILL. My fellow was on an October 31 year. but my transaction occurred in his 1984 fiscal year.

Senator CHAFEE. Yes. All right. Thank you.

The CHAIRMAN. Senator Long?

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much. Now, we will take a panel consisting of Martin Wood, Russell Shaw, James Carter, and my old friend, Morton Zalutsky, from Portland, OR. All of your statements will be in the record in full. Mr. Wood, why don't you go right ahead?

STATEMENT OF MARTIN D. WOOD, DIRECTOR, RETIREMENT, SAFETY, AND INSURANCE DEPARTMENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, WASHINGTON, DC

Mr. WOOD. Mr. Chairman, members of the committee, thank you for this opportunity to appear. In addition to the statement which you have before you, I would request that we include a supplementary statement which deals with one of the items as it is affected by the President's tax reform proposal. I would also request that we include a letter from the Joint Tax Committee which refers to the revenue impact of one of the items to which we are referring.

The CHAIRMAN. Let me ask you this. This would be in lieu of your testifying on tax reform, I take it, because this is not a tax reform hearing?

Mr. WOOD. Not necessarily. We simply thought that this, because it does impact on what I am about to speak to, should perhaps be put in the record, and it was not possible for us to do that since the President's proposal was so recent.

The CHAIRMAN. Since the President's proposal was what?

Mr. WOOD. It was so recent.

The CHAIRMAN. It will go in the record. This is not a hearing on the President's tax reform proposals, and I would just as soon not have a great deal of testimony put it on the tax reform bill itself.

Mr. WOOD. I understand.

The Chairman. It will go in the record, but if it relates to that and we have more witnesses than we can have on the tax reform proposal, then we may not have you testify there. Go right ahead.

Mr. WOOD. I understand that, sir. Our reason for appearing is to lend emphasis to that which we are requesting through the formal statement, and also to present myself for questioning. Rural electric cooperatives throughout the country, of which there are 1,000, must compete for highly qualified employees with investor-owned utilities. This is an important aspect of their work. We therefore have to have a very fine compensation package which must include good benefit programs to be competitive. We have such a program, but it lacks one item, the so-called 401K. We do not have that available to our cooperatives. The basic reason for this is that we have a national scope to our plan, as opposed to a limited scope, we need to clarify the authority for nonprofits to adopt such plans, and a few State laws affect the operation of cooperatives. I would like to emphasize that the change which we seek resolves a problem which is unique to rural electric cooperatives, does not alter tax policy, and according to the Joint Tax Committee, has negligible impact on revenue.

With respect to the Retirement Equity Act of 1984, we recognized in the National Rural Electric Cooperative Association that using the PBGC rate was desirable, and we did this several years ago before it became law. We have been using it, and we have gained experience thereby. We offer the benefit of that experience for your consideration. We would like to be helpful. Our proposal recommends flexibility to permit an average rate over a 12-month period to more fairly reflect the trend in interest rates. It also has other minor allowances to facilitate orderly administration, to make the predictability of the lump sum possible for the employee, and consistency among participants. I would like to thank the committee on behalf of the 1,000 rural electric cooperatives throughout the country who are extremely interested in this action. Thank you.

The CHAIRMAN. Thank you, sir. Mr. Shaw?

[The prepared written statement of Mr. Wood and the Joint Tax Committee letter follow:]

NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W. Washington, D.C. 20036/202-857-9500

STATEMENT OF THE NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION RELATING TO HEARINGS ON S 814, THE TECHNICAL CORRECTIONS ACT OF 1985, AND ON TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984, BEFORE THE SENATE COMMITTEE ON FINANCE

June 5, 1985

Mr. Chairman and members of the Committee, my name is Martin D. Wood. I am the Director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association (NRECA) and the Administrator of the various welfare and pension programs sponsored by NRECA and its members. NRECA is the national service organization of the approximately 1,000 rural electric systems operating in 46 states. These systems bring central station electric service to approximately 25 million farm and rural individuals in 2,600 of our nation's 3,100 counties. Our various programs provide pension and welfare benefits to over 110,000 employees and their dependents in those localities.

The purpose of my comments to you today is to bring to your attention two technical issues--the first concerning the ability of rural electric cooperatives to adopt salary reduction arrangements, which may be appropriately addressed in S 814; and the second concerns a proposal for improving the methods allowed for calculating the Pension Benefit Guaranty Corporation (PBGC) interest rate for lump sum payments, which you may wish to include in any technical corrections made to the Retirement Equity Act of 1984. With your permission, I will begin my testimony by discussing our problems with adopting a section 401(k) plan.

401(k) PLANS AND RURAL ELECTRIC COOPERATIVES

Prior to 1972 the Internal Revenue Service permitted profit sharing, stock bonus and money purchase pension plans to include cash or deferred arrangements. See, Rev. Rul. 68-89, 1968-1 C.B. 402, Rev. Rul. 63-180, 1963-2 C.B. 189, Rev. Rul. 56-497, 1956-2 C.B. 284. These rulings permitted cash or deferred arrangements in profit sharing plans and established a nondiscrimination test of whether a majority of the participants in the plan were in the lowest paid two-thirds of eligible employees. The plans discussed in the early rulings were profit sharing plans giving each participant the individual election to either receive a profit sharing bonus in cash or have the bonus contributed to his account in a profit sharing plan. Although the rulings involved only profit sharing plans, the IRS also issued qualification letters to stock bonus and money purchase pension plans. The rulings (and the early cash or deferred plans) involved only elective contributions to profit sharing plans. However, these types of plans were soon expanded to include arrangements in which employees voluntarily elected to reduce their cash compensation and have the balance contributed to a profit sharing plan. This variation is generally referred to as a salary reduction plan.

On December 6, 1972 the IRS issued proposed regulations which would have changed the result for salary reduction plans and called into question the viability of cash or deferred profit sharing arrangements. In order to allow time to study the area Congress enacted section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) which temporarily froze the status quo. The IRS was prohibited from enforcing its proposed regulations for plans in existence on June 27, 1974 and no further plans with such features could be commenced until Congress finished its study. This freeze was subsequently extended twice, one in the Tax Reform Act of 1976 and once in the Tax Treatment Extention Act.

The Revenue Act of 1978 added section 401(k) to the Internal Revenue Code, authorizing cash or deferred arrangements in profit sharing and stock bonus plans. Section 401(k) did not authorize cash or deferred arrangements in money purchase pension plans. While proposed regulations extend section 401(k) to cover salary reduction plans, they do not allow money purchase pension plans to adopt 401(k) arrangements. Prop. Treas. Reg. section 1.401(k)-1(a)(1).

The freeze on cash or deferred arrangements in pre-ERISA plans expired January 1, 1980. Since section 401(k) was then in force, the expiration of the freeze did not affect profit sharing or stock bonus plans with 401(k) features. However, there are a number of pre-ERISA money purchase pension plans that had adopted salary reduction arrangements. The expiration of the freeze left them out in the cold since 401(k) applies only to profit sharing or stock bonus plans. Legislation was accordingly introduced in the 97th Congress (H.R. 4948) to provide grandfather protection for money purchase pension plans that before June 27, 1974 had adopted salary reduction arrangements. The primary impetus for action came from a group of money purchase pension plans in the South and Southwest. Those plans principally covered employees of the Federal Land Bank, Bank for Cooperatives, and various production credit associations, most of which are tax-exempt organizations. During hearings on H.R. 4948, Treasury expressed its support of the bill and urged Congress to act to extend the availability of section 401(k) to all money purchase pension plans. Miscellaneous Tax Legislation: Hearing before the Subcommittee on Select Revenue Measures, 97th Cong. 2d Sess. 12 (1982) (Statement of John E. Chapoton). H.R. 4948 died in the closing days of the 97th Congress, however.

H.R. 4948 was reintroduced in the 98th Congress as H.R. 3173, subsequently incorporated into the Tax Reform Act of 1984 as section 527(b), and enacted. During hearings on H.R. 3173, Treasury again stated its support of the concept of extending section 401(k) rules to all money purchase pension plans. Statement of Robert G. Woodward, Tax Legislative Counsel, on H.R. 3173 before the Subcommittee on Select Revenue Measures (September 21, 1983). As provided in the Tax Reform Act of 1984, a money purchase pension plan with a salary reduction feature in existence on June 27, 1974 may continue the salary reduction feature provided that (1) the contributions to the plan are not increased over the June 27, 1974 contribution formula and (2) the plan meets the special eligibility and discrimination rules of section 401(k).

It is unfortunate that section 527 of the Tax Reform Act of 1984 did not extend section 401(k) to all money purchase pension plans. H.R. 1615, introduced March 20, 1985, and S. 896, introduced April 4, 1985 are intended to clarify that rural electric cooperatives may incorporate 401(k) features into their money purchase pension plans. Rural electric cooperatives are tax exempt, consumer owned utilities operating principally in rural areas of America. The approximately 1,000 rural electric cooperatives operate in 46 states and a majority of the counties of the United States.

H.R. 1615 and S. 896 are actually codifications of the existing ability of tax exempt rural electric cooperatives to adopt salary reduction arrangements. In 1983 a General Counsel Memorandum was released by the IRS which recognized that tax exempt, nonprofit organizations could adopt profit sharing plans. G.C.M. 38283 (February 15, 1980). Relying on G.C.M. 38283 an increasing number of tax exempt organizations have adopted profit sharing plans with 401(k) salary reduction features. Therefore, rural electric cooperatives could possibly take the same approach as other tax exempt organizations and adopt profit sharing plans with 401(k) features. However, such an approach is not advisable because of the unique factors involved with rural electric cooperatives.

Although G.C.M. 38283 permitted profit sharing plans for tax exempt organizations, the National Office of the IRS is not presently issuing opinion letters for such plans with salary reduction features. Therefore, to adopt a 401(k) plan the 1,000 rural electric cooperatives would, contrary to their present practice, have to each individually adopt a profit sharing plan to be approved in the 10 IRS key district offices of the United States. Since not all IRS districts are approving such plans, there would be inconsistencies from region to region. Furthermore, since rural electric cooperatives operate in 46 states, it seems that in at least some states local law might prohibit cooperatives from adopting profit sharing plans. Any excess of revenues over expenses is automatically allocated to the cooperative patrons under state law and not available for contribution to a profit sharing plan.

Thus, while it might be possible for rural electrics to adopt profit sharing plans they do not wish to do so. What they want to do is to incorporate salary reduction features in their existing money purchase plans, which are organized and administered on a national basis. Codification of their ability to do so avoids the problems involved with profit sharing plans and the risk that the IRS might change its opinion in G.C.M. 38283.

Since the treatment of pre-ERISA money purchase pension plans with cash or deferred arrangements was affected in the Tax Reform Act of 1984, it is appropriate to now correct the law to cover certain post-ERISA money purchase pension plans. H.R. 1615 and S. 896 have been reviewed by staff of the Joint Committee on Taxation and found to be of negligible revenue impact.

INTEREST RATE ASSUMPTIONS
LUMP SUM PENSION DISTRIBUTIONS

The Retirement Equity Act of 1984 (REACT) requires that the interest rate assumption used in calculating the present value of a pension benefit distributed in a lump sum not be greater than the interest rate used (on the date of distribution) by the Pension Benefit Guaranty Corporation (PBGC) for valuing lump sum distributions on plan terminations. REACT section 205(a). The committee reports state that a plan may provide that the PBGC interest rate in effect on the first day of the plan year be used throughout the plan year. S. Rep. No. 575, 98th Cong., 2d Sess. 24 (1984).

Providing a PBGC referenced interest rate assumption is a salutory change that significantly protects plan participants from unfair or arbitrary interest rate assumptions in valuing lump sum distributions. We feel, however, that the rules provided in REACT are not flexible enough to accommodate the needs of some pension plans in the orderly administration of their pension benefits. To illustrate some of these concerns we will use as an example the multiple employer, master defined benefit pension plan sponsored by the National Rural Electric Cooperative Association (the "NRECA pension plan").

Before the passage of REACT, the NRECA pension plan had provided for the use of the PBGC rate for the calculation of lump sum payments to plan participants. However, the specific method used by the NRECA pension plan does not conform to the REACT specifications in several regards. The NRECA pension plan provides for one PBGC rate to be in effect for the 12 month period from April 1 of one year to March 30 of the next year. The rate to be used for that period is the average PBGC rate in effect over a 12 month period ending June 30. Thus an average PBGC rate is calculated and then becomes effective nine months later. While the method used by the NRECA pension plan varies from REACT in three ways, each difference is occasioned by significant concerns for the orderly administration of the NRECA pension plan.

1. Average Rates. While REACT made no provision for average rates, we feel that a 12 month average is a fairer reflection of the trend of interest rates. It provides over the entire participant population a fairer distribution of lump sum values than a PBGC rate in effect during one month of the year.

2. Spans Two Years. Since in our experience the great majority of retirements occur on December or January, a change of rate at the beginning of a plan year introduces a great variation in lump sum values among retirees. We are also greatly concerned with the administrative difficulty of changing the lump sum calculation in the middle of the most active retirement period.

3. Nine Month Lag. Potential retirees need stable retirement projections and time to plan for their retirement. We, therefore, allowed a period of nine months from the calculation of the interest rate until it became effective to allow for participant planning before their retirement actually occurs.

While we agree with the need to specify PBGC interest rates for lump sum calculations, we fear that there is not sufficient flexibility provided in REACT to enable the IRS to approve pension plans that may, for good administrative reasons, have variations on the REACT specified method. NRECA therefore suggests that the committee reports accompanying any technical corrections to the Retirement Equity Act of 1984 provide that the Commissioner may issue favorable determination letters to plans providing for PBGC rates in calculating lump sum amounts by methods the Commissioner finds reasonable under the circumstances. The circumstances to be considered should include the orderly administration of the plans, predictability of the lump sum amounts and consistency among the plan participants. For example, an average PGBC rate or one covering a twelve month period spanning two plan years could be permitted by the Commissioner.

This concludes my testimony on the need for clarifying the ability of rural electric cooperatives to adopt salary reduction arrangements and our proposal to allow additional flexibility in the calculation of the PGBC interest rate for lump sum distributions. I remain willing to respond to any questions the Committee may have now or after this hearing.

NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W. Washington, D.C. 20036/202-857-9500

SUPPLEMENTAL STATEMENT OF THE NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION RELATING TO HEARING ON S 814, THE TECHNICAL CORRECTIONS ACT OF 1985, BEFORE THE SENATE FINANCE COMMITTEE

JUNE 5, 1985

Mr. Chairman and members of the Committee, my name is Martin D. Wood. I am the Director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association (NRECA) and the Administrator of the various welfare and pension programs sponsored by NRECA and its members. NRECA is the national service organization of the approximately 1,000 rural electric systems operating in 46 states. These systems bring central station electric service to approximately 25 million farm and rural individuals in 2,600 of our nation's 3,100 counties. Our various programs provide pension and welfare benefits to over 110,000 employees and their dependents in those localities.

I appreciate the opportunity to supplement my previous written statement which was filed with the Committee May 29, 1985. On the day before the Department of Treasury released the President's Tax Proposals and there was not sufficient time to comment on the provisions that affect my testimony today.

The President's Tax Proposals state that section 401(k) cash or deferred arrangements would not be available to employees of tax-exempt organizations or public employers. The reason given for denying 401(k) plans to such employers is that tax-exempt organizations and public sector employers will have tax sheltered annuities (I.R.C. section 403(b)) and/or tax favored elective deferred compensation arrangements (I.R.C. section 457) available for their employees. The proposal also provides that all tax-exempt organizations will be covered by the provisions of I.R.C. section 457; presently only public sector employers and rural electric cooperatives are covered by section 457. Therefore the Treasury reasons, it would be duplicative to extend 401(k) plans to public sector employers and tax-exempt organizations.

Since rural electric cooperatives have been covered under section 457 the same as States since 1978, we can emphatically state that it is not duplicative to extend 401(k) plans to tax-exempt rural electric cooperatives.

Rural electric cooperatives are not charitable or educational organizations, nor states or the agency or instrumentality of any of the foregoing. Therefore, they can not offer tax-sheltered annuities to their employees. I.R.C. section 403(b)(1)(A).

Rural electric cooperatives are subject to section 457 and may offer tax favored elective deferred compensation arrangements to their employees, but not to all employees as may a State government. A deferred compensation plan offered to all employees is considered a pension plan under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA section 3(2)(A). However, since governmental units are exempt from ERISA, this has no effect on their deferred compensation programs under I.R.C. section 457 and governmental units may freely offer their elective deferred compensation plans to all employees. ERISA section 4(b)(1).

Since rural electric cooperatives are not states or other governmental units, they are subject to the provisions of ERISA. ERISA requires that any pension plan (such as a section 457 deferred compensation plan offered to all employees) must meet certain funding requirements and its assets must be held in trust. ERISA sections 301 and 403(a). If such plans are funded and trusteed, then the tax deferral to the employee granted by section 457 is lost. I.R.C. section 457(b)(6), Treas. Reg. section 1.457-3(b). The only way to preserve the tax deferrals under a section 457 deferred compensation plan for rural electric cooperative employees is to limit the coverage of the plan to a select group of management or highly compensated employees. An unfunded plan covering a select group is subject only to the reporting and disclosure rules of ERISA and not to the participation and vesting, funding and trustee rules. ERISA sections 201(a)(2), 301(a)(3), and 401(a)(1). I have attached an advisory opinion letter of the Department of Labor dated November 4, 1981 which was issued to a member system of NRECA and confirms this analysis of the interaction of ERISA and section 457.

In summary, rural electric cooperatives cannot offer elective deferred compensation programs to their rank and file employees but must, under ERISA, limit them to a select group of management or highly compensated employees. This places rural electrics at a disadvantage in competing for employees with investor owned utilities. Investor owned utilities can offer 401(k) plans to all employees and elective deferred compensation plans to a select group. Rural electric cooperatives would not be able to offer 401(k) plans to any employees and could offer elective deferred compensation plans to only a select group.

99TH CONGRESS, 1ST SESSION

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JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
Washington, D.C. 20515

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DEPUTY CHIEF OF STAFF

FEB 19 1985

Honorable Wyche Fowler
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Fowler:

We are responding to your request for a revenue estimate of the effect of extending the qualified cash or deferred arrangement rules (sec. 401(k) of the Code) to certain money purchase pension plans.

We estimate that this proposal will have a negligible effect on budget receipts. Our analysis is based on the draft language submitted to us by Bill Johnstone on January 28, 1985, which limits the extension to the pension plan maintained by the National Rural Electric Cooperative Association and its member cooperatives.

If we can provide you with any further assistance, please contact us.

Sincerely,

David H. Brockway

David H. Brockway

U.S. Department of Labor

[illegible]
[illegible]

[illegible]
Pension and Welfare Benefit Programs

[illegible] - 4 [illegible]

Mr. Roger R. Kemppel
Kemppel, Huffman & Ginder
255 E. Fireweed Lane, Suite 200
Anchorage, Alaska 99503

Dear Mr. Kemppel:

This is in reply to your request dated February 17, 1981, for an advisory opinion concerning the coverage of the Matanuska Electric Association, Inc. Deferred Compensation Plan (the Plan) under the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, you ask whether the Plan is exempt from the provisions of ERISA by virtue of its being a "governmental plan" within the meaning of ERISA section 3(32). Since the Department of Labor (the Department) is responsible for the administration of title I of ERISA, this letter addresses only that title.

Your letter contains the following representations. Matanuska Electric Association, Inc. (Matanuska), is a rural electric cooperative incorporated under the laws of Alaska. Matanuska is exempt from Federal income taxation under Internal Revenue Code (Code) section 501(a) as an exempt organization described in Code section 501(c)(12).

Code section 457 provides a category of deferred compensation plans for State and local government agencies and rural electric cooperatives. The Plan is intended to meet the requirements of section 457 of the Code which was added to the Code by the Revenue Act of 1978.

While governmental plans (as defined in section 3(32) of ERISA) are expressly excluded from the application of title I of ERISA by reason of the exclusion in ERISA section 4(b)(1), plans of rural electric cooperatives are not so excluded from the application of ERISA if they are not "governmental plans." Code section 457 provides that plan participants of deferred compensation plans which are established and maintained by a State as defined in Code section 457(d)(1) or by a rural electrical cooperative as defined in Code section 457(d)(9)(B) and which comply with the requirements of Code section 457 may defer taxation on the amounts contributed until the income is paid or otherwise made available to the participant or beneficiary.

Because Code section 457 of the Code requires, inter alia, that any deferred compensation to be eligible for the treatment accorded under section 457 must generally provide that, absent an unforeseeable emergency, the plan not make payments available to participants and beneficiaries prior to the participants separation from service from the employer. You correctly infer that the plan would be a pension plan subject to title I of ERISA if it is not considered a "governmental plan" under ERISA section 3(32). (Section 4(b)(1) of ERISA provides that title I of ERISA shall not apply to governmental plans, which are defined in section 3(32).) In pertinent part, section 3(32) of ERISA defines a governmental plan as "a plan established or maintained by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing." You have not provided any factual material to support a ruling that the Plan is "a plan established or maintained for its employees . . . by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing," which is the standard for determining whether a plan is a governmental plan under ERISA. However, you argue that plans of rural electrical cooperatives must be considered governmental plans because they otherwise would have to be funded, which would contravene the requirement of Code section 457 that plan assets must be subject to the claims of the general creditors of the employer. You argue, therefore, that all plans of rural electrical cooperatives must be considered "governmental plans" or else Code section 457(d)(9) would have no meaning. The Department does not interpret section 457 of the Code. We wish to note, however, that we do not believe that section 457(d)(9) of the Code is necessarily rendered meaningless if plans of rural electric cooperatives are not governmental plans within the meaning of title I. It appears that unfunded deferred compensation plans may be maintained by rural electric cooperatives under Code section 457 if such a plan is an excess benefit plan as defined in section 3(36), or is a plan maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees as that term is used in ERISA sections 201(2), 301(3) and 401(1) but not for all the employees of such rural electrical cooperatives. *

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,

Ian D. Lanoff
Administrator
Pension and Welfare Benefit Programs

STATEMENT OF RUSSELL C. SHAW, THOMPSON, HINE & FLORY, CLEVELAND, OH

Mr. **Shaw**. Thank you, Mr. Chairman and members of the committee. Although our firm represents insurance agents and, on occasion, life insurance companies, I am here *pro bono* on behalf of the interest of individuals who have split-dollar insurance arrangements with their employers. As you are probably aware, split-dollar insurance provides a death benefit during the working life of employees and beyond. It is maintained by the employer through permanent insurance. Since it is a death benefit, it would be by definition a welfare benefit, but it is maintained on a nontax-deductible basis to the employer, and, to the extent the employee does not pay the cost of the insurance, it is included in his gross income through so-called "P.S. 58" rates. These arrangements are not tax shelters. They do not result in any acceleration of tax deductions to the employers. In fact, the employer never gets a deduction for payments under the policy because the employer is a beneficiary, and therefore, it is excluded under section 264 of the Code. The proposed addition of paragraph (4) to Section 419(e) of the Code, as added by the 1984 Act, would extend the definition of welfare benefit fund to these types of arrangements. This means that the arrangements not only would be subject to the section 419(a)(e) limit on $50,000 of post-retirement death benefits to the employees, but it also would subject the beneficiaries' receipt of the proceeds to the 100 percent excise tax under section 4976. We do not believe that Congress intended this result. If you read the Congressional hearings and reports, there is no indication at all that this was intended. So, we do not believe that at this time, through a Technical Corrections Act, a major change in tax policy, which has been longstanding since the 1950s or 1960s, should be made. We would ask that Congress specifically exclude split-dollar insurance arrangements from the definition of funded welfare benefit plan, and if it cannot do that, that it would at least indicate or reaffirm its intent not to include these arrangements through the Technical Corrections Act. If, in fact, Congress has changed its collective mind and wants to include these arrangements now, we would ask that appropriate grandfather provisions be enacted to give relief to those people who already have the arrangements in effect. Thank you for your time.

The **Chairman**. Thank you, sir. Mr. Carter?

[The prepared written statement of Mr. Shaw follows:]

STATEMENT
OF
RUSSELL C. SHAW
BEFORE
SENATE COMMITTEE ON FINANCE
ON
TECHNICAL CORRECTIONS ACT OF 1985 (S. 814)
JUNE 5, 1985

I. INTRODUCTION

We appreciate the opportunity to comment with respect to certain aspects of the Technical Corrections Act of 1985 (S. 814) and the related provisions of the Tax Reform Act of 1984 ("DEFRA"). While we generally support the provisions of the Technical Corrections Act, we find certain aspects of the Act disturbing. In particular, we believe that at least one provision goes beyond being a mere "technical" correction of DEFRA and should be deleted from the Technical Corrections Act.

Our concern focuses on Section 419(e) of the Internal Revenue Code of 1954 (the "Code"), as added by Section 511 of DEFRA and as proposed to be amended by Section 151 of the Technical Corrections Act through the addition of a new paragraph (4). We believe that the definition of "funds," prior to the addition of the proposed new paragraph (4), could possibly, but erroneously, be construed to include so-called "split dollar" insurance arrangements. (Split dollar insurance arrangements do not result in any employer deductions and are discussed in detail below.)

While we find no evidence that Congress intended Section 419 of the Code to cover such split dollar insurance arrangements, the addition of paragraph (4) seems to specifically extend Section 419(e) of the Code to split dollar insurance arrangements and remove any doubt that such arrangements are to be treated as "funded" welfare benefit plans.

If this is the result of the addition of paragraph (4), whether or not intended, the consequences would be disastrous to employers and their employees who are covered by split dollar insurance arrangements. Therefore, we strongly urge that Congress either make an exception for such split dollar insurance arrangements or redraft the proposed language so as to exclude any plan or arrangement the funding of which the employer is denied a deduction under Section 264 of the Code or any similar section.

II. SPLIT DOLLAR INSURANCE ARRANGEMENTS

Normally, under a split dollar insurance arrangement, the employer and employee join in purchasing an insurance contract, in which there is a substantial investment element, on the life of the employee. Usually, the employer pays that part of the annual premium which equals the current year's increase in the cash surrender value of the policy, and the employee pays the balance, if any, of the premium. If the employee dies while the split dollar insurance plan is in effect, the employer normally receives from the proceeds of the policy an amount equal to the cash value of the policy, and the employee's beneficiaries receive the balance of the proceeds. There are several variations of this basic split dollar insurance arrangement, but this type of arrangement is usually maintained on the lives of "key employees", as defined in Section 416(i) of the Code.

The income tax consequences of a split dollar insurance arrangement between an employer and an employee have remained unchanged since 1964 when the Internal Revenue Service issued Revenue Ruling 64-328, 1964-2 C.B. 11, which held:

> Where an insurance policy is purchased on the life of an employee under a so-called "split dollar" arrangement in which the employer provides the funds to pay the portions of the premiums equal to the increases in the cash surrender value of the policy and the employee is to pay the balance, if any, of the premiums, and in which, from the proceeds of the policy payable at the employee's death, the employer will receive an amount generally equal to the cash surrender value of the policy and the employee's beneficiaries will receive the balance, the employee must include in his income the value of the insurance protection in excess of the portions, if any, of premiums provided by him. Held also: No deductions shall be allowed to the employer for premium payments made. Held also: The proceeds of the policy payable upon death of the employee are subject to Section 101(a) of the Internal Revenue Code of 1954.

Id. at 11. (Emphasis added.)

The main benefit received by the employee is the current insurance protection under the basic policy.

The value of this benefit to the employee is usually calculated by use of the Service's one-year term premium rates, the so-called "P.S. 58" rates. The applicable rate for the insured's age in the taxable year is applied to the difference between the employer's share of the death benefit and the full death benefit payable under the policy. If the insurance company which issues the policy publishes rates for individual, initial issue, one-year policies that are lower than the P.S. 58 rates, those rates may be substituted for the P.S. 58 rates. Rev. Rul. 66-110, 1966-1 C.B. 12. Policy dividends constitute an additional economic benefit to the employee if they are received by him in cash or applied for his benefit. The value of this additional benefit is the actual dollar amount of the dividend so received or used to buy additional insurance. Rev. Rul. 66-110, supra. The values of all economic benefits received by the employee in the taxable year are added; this would include the P.S. 58 value of the life insurance protection for the year, plus the dollar value of dividends received by the employee or applied for his benefit. The employee's portion of the premium payment for the taxable year is then subtracted from the total value of the economic benefits received. The remainder, if any, is the amount that the employee must report as taxable income.

The actual premium payments made by the employee are not deductible since life insurance protection for an individual is a nondeductible personal expense. I.R.C. §262. Likewise, premium payments by the employer under a split dollar insurance arrangement are not deductible since the employer will be a beneficiary of the policy. I.R.C. §264(a)(1); Rev. Rul. 64-328, supra at 15.

III. SECTIONS 419 AND 419A OF THE CODE

Since a split dollar insurance arrangement provides no deduction for employers for yearly premiums paid and results in ordinary income to the employee to the extent of the insurance benefit received (but not paid for) by him, we believe it is necessary to examine the congressional intent behind Sections 419 and 419A of the Code to determine whether split dollar insurance agreements were intended to fall within the ambit of these sections.

The House Committee on Ways and Means Report clearly sets forth the scope of the coverage that Congress intended the definition of welfare benefit fund to include. The Committee Report emphasizes:

> The bill provides additional rules for determining the timing and the amount of an employer's deduction for contribution to a funded welfare benefit plan. Under the bill, a contribution which is otherwise deductible under the Code will be deductible only to the extent that it does not exceed the qualified cost of the plan for the taxable year. . . .

The House Comm. on Ways and Means, Supplemental Report on H.R. 4170, Rept. 98-432, Pt. 2, 98th Cong., 2d Sess. 1276 (1984). (Emphasis added.)

Similarly, the Statement of the Managers of the Conference Report on H.R. 4170 emphasizes this same position in the following language:

> Definition of welfare benefit fund. In general, this section of the bill applies to contributions to welfare benefit funds which are organizations, reserves or accounts held by organizations, to which an employer provides welfare benefits to employees or their beneficiaries. In prescribing regulations relating to the definition of the term "fund," the conferees wish to emphasize that the principal purpose of this provision of the bill is to prevent employers from taking premature deductions, for expenses which have not yet occurred, by interposing an intermediary organization which holds assets which are used to provide benefits to the employees of the employer. Thus, a retired life reserve or premium stabilization account ordinarily is to be considered a fund or part of a fund, since such an account is maintained for an individual employer and that employer has a determinable right to have the amount in such account applied against the employer's future cost of benefit claims or insurance premiums. A similar situation exists with respect to premium arrangements, under which an employer may, in some cases, pay an insurance company more in a year than the benefit costs incurred in that year and the employer has an unconditional right in a later year to a refund or credit of the excess payment over the benefit cost. . . .

Statement of Managers, H.R. No. 98-861, 98th Cong., 2nd Sess. 1155 (1984). (Emphasis added.)

It is clear that Congress did not intend to cover split dollar insurance arrangements when it established new requirements for welfare benefit funds, inasmuch as the employer never gets a deduction for its payment of premiums in a split dollar insurance arrangement. Rather, the obvious intent of Congress, readily apparant from the

Committee Report, was that the definition of a welfare benefit fund contained in Section 419(e) of the Code should include only those types of benefits provided by an employer for which the employer would normally receive a deduction under the Code. Since it is clear that an employer receives no deduction for its share of the split dollar insurance premium it pays and since such insurance arrangements are in no way abusive tax shelters, this is not the type of benefit which Congress meant to bring within the ambit of the definition of a welfare benefit fund.1/ Since Congress did not intend split dollar insurance arrangements to be covered under Sections 419 and 419A of the Code, we find it most disconcerting that a major change in tax policy with respect to split dollar insurance programs is now proposed to be made through passage of a technical corrections act. Yet this will be the result if Section 151 of the Technical Corrections Act is passed in its present form.

IV. SECTION 151 OF THE TECHNICAL CORRECTIONS ACT OF 1985

Although contrary to the clear legislative intent and long-standing administrative policy, an argument can be made that Section 419 of the Code, as it is currently

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1/ Congress was determined to stop the use of funded welfare benefit plans as abusive tax shelters, and Section 419 and 419A of the Code were the result. See House Comm. on Ways and Means, Supplemental Report on H.R. 4170, supra, at 1275-76.

written, covers split dollar insurance arrangements. The addition of new paragraph (4) contained in Section 151 of the Technical Corrections Act 2/, however, clearly brings split dollar insurance arrangements within the definition of a welfare benefit fund in spite of the fact that this was not intended by Congress when it enacted DEFRA. We believe that the new proposed paragraph (4) extends the definition of "welfare benefit fund" to programs such as split dollar insurance, inasmuch as the benefit provided to an employee by a split dollar insurance arrangement is a death benefit (and, therefore, by definition a "welfare benefit") and this type of benefit is funded through an insurance contract with cash surrender values or other permanent insurance features (and, therefore, by definition is a "fund" if the program otherwise comes within the statutory definition of "fund" under Section 419 of the Code).

The consequence of this disturbing expansion would be that benefits paid to many, if not a majority, of employers whose employees are covered by split dollar insurance arrangements will be subject to the 100 percent excise tax imposed by Section 4976 of the Code, inasmuch as benefits in many instances will be paid subsequent to an

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2/ The pertinent text of Section 151 of the Technical Corrections Act is set forth in Appendix A.

employee's termination of employment or retirement and, in almost all cases, are maintained on the lives of "key employees". Furthermore, this expansion will result in an employer's being subject to the excise tax under Section 4976 of the Code whenever it recoups a premium or any other amount under a split dollar insurance arrangement that is maintained on the life of a "key employee". We cannot believe that such a major change in the tax policy is contemplated through a technical correction of a defined term in DEFRA. Rather, we believe that this would be an unintended result of the proposed addition of new paragraph (4) and urge that Congress explicitly exclude split dollar insurance arrangements from the coverage of Sections 419 and 419A of the Code. At a minimum, the lack of any congressional intent to cover split dollar arrangements when DEFRA was enacted should be reaffirmed.

V. CONCLUSION

For all the foregoing reasons, we strongly urge enactment of an explicit exception for split dollar insurance arrangements or a clear statement of congressional intention that these arrangements not be covered by Sections 419 and 419A of the Code. If, contrary to longstanding administrative policy and its own intention in enacting DEFRA, Congress now intends that Section 419 and 419A of the Code apply to split dollar insurance arrangements, we ask that existing arrangements be grandfathered, inasmuch as they are in no way abusive and thousands of people would be irreparably damaged by the application of these sections to existing split dollar insurance arrangements.

Appendix A

Section 151 provides in pertinent part as follows:

(8) CLARIFICATION OF FUND.--Subsection (e) of section 419 (defining welfare benefit funds) is amended by adding at the end thereof the following new paragraph:

> "(4) TREATMENT OF AMOUNTS HELD PURSUANT TO CERTAIN INSURANCE CONTRACTS.--
>
> "(A) IN GENERAL.--Notwithstanding paragraph (3)(C), the term 'fund' shall not include amounts held by an insurance company pursuant to an insurance contract if--
>
> "(i) there is no guarantee of a renewal of such contract, and
>
> "(ii) other than insurance protection, the only payments to which the employer or employees are entitled are experience rated refunds or policy dividends which are not guaranteed and which are determined by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries.
>
> "(B) LIMITATION.--In the case of any insurance contract described in subparagraph (A), subparagraph (A) shall not apply unless the amount of any experience rated refund or policy dividend payable to an employer with respect to a policy year is treated by the employer as received or accrued in the taxable year in which the policy year ends."

STATEMENT OF JAMES CARTER, SENIOR TAX COUNSEL, ICI AMERICAS, INC., WILMINGTON, DE

Mr. CARTER. Mr. Chairman and Senators. In 1984, the act imposed a limitation upon the funding of voluntary employee beneficiary associations, chiefly to correct perceived abuses in employer funding. All voluntary employee beneficiaries associations are not employer funded, of course. Many of them—including the three on whose behalf I speak—are funded entirely by employee contributions. Nobody gets a tax deduction from these contributions. The employees can't deduct it from their own income, so these are in effect after tax money going into the VEBA. The limitation imposed on funding, however, goes across the board with an exception for those associations that are held by tax exempt organizations. What we are requesting is that that same exemption be extended to those associations that are entirely employee funded. And the reason is that the way the bill now reads, it forces the employee-funded associations to either put all of the money with an insurance company, into the insurance company's reserve—premium stabilization reserve fund—which is a lower rate of return, a lower benefit to the members of that association, or else it forces the association itself to start some kind of a fluctuating premium arrangement where you have an experience rated insurance plan. Certainly, you can't have a voluntary employee beneficiary association operate on a fluctuating premium arrangement. Members simply won't contribute their money to it. You need a premium stabilization reserve. So, the net effect of the act in this context is to force these VEBA's to go entirely into insurance company stabilization reserves, with the result that you are going to get lower benefits, less insurance with the money that is being paid in. We don't think that is what Congress intended. We think what Congress intended initially was to prevent the employer funded abuses, and this I think is borne out by the exception for the tax-exempt organizations. We therefore ask that this same exception be extended to the entirely or substantially employee funded beneficiary associations.

The CHAIRMAN. Mort? Mort Zalutsky is an old, old acquaintance and friend of mine whom I call upon for counsel and advice numerous times. It is good to have you with us this morning.

[The prepared written statement of Mr. Carter follows:]

STATEMENT OF JAMES M. CARTER
SENIOR TAX COUNSEL
ICI AMERICAS INC.
BEFORE THE SENATE
FINANCE COMMITTEE
IN RESPECT OF
THE TECHNICAL CORRECTIONS ACT OF 1985
ON
5 JUNE 1985

My name is Jim Carter, Senior Tax Counsel, ICI Americas Inc., a Delaware corporation. This statement is made on behalf of three Voluntary Employee Beneficiary Associations ("VEBAs"), exempt from taxation under Internal Revenue Code ("Code") section 501(c)(9), that provide life insurance or long term disability insurance to more than 8,000 participants. All three VEBAs are funded entirely with the after tax dollars of participating employees of ICI Americas. ICI Americas obtains no tax advantage from these VEBAs since the Company makes no contributions to them. Participation is entirely voluntary. My testimony will point out how amendments to Internal Revenue Code section 512 made by the Deficit Reduction Act of 1984 ("DRA") inadvertently penalize non-abusive, employee payall VEBAs and, probably unintentionally, subsidize the insurance industry. We request relief in the Technical Corrections Act of 1985.

Two of the subject VEBAs provide only group term life insurance. The third one provides long term disability benefits with an ancillary death benefit. Participants make contributions at a level rate. The VEBAs, through a bank trustee, pay the premiums for group term policies to an insurance company. The premiums are experience rated. A premium stabilization reserve is held by the trustee to prevent current contribution fluctuations concomitant with changes in the experience rated premium.

In 1986, the income of VEBAs funded substantially by after tax employee contributions becomes subject to the unrelated business income tax to the extent any set-aside of such income exceeds a "permissible amount." This result follows from new Code section 512(a)(3)(E) that treats a VEBA that holds a reserve in excess of the "permissible amount" as subject to tax under Code section 511. The "permissible amount" is the qualified asset account limit determined under Code section 419A. Code section 419A, as currently drafted, will effectively limit permissible reserves ("set-asides") (1) to zero if benefits are provided through an insurance policy or (2) to the amount of accrued, unpaid claims at year end where benefits are paid directly by a VEBA. Such a current disbursements reserve is generally insufficient to provide life insurance or disability benefits in an employee payall VEBA. An employee payall VEBA must have a premium stabilization reserve to avoid rapid and possibly extreme fluctuations in contributions by participants. No employee funded life insurance or disability benefit program could retain enough participation to survive if it had to change the amount of regular contributions constantly. Thus, employee funded life insurance or disability VEBAs will be required to deposit reserve funds with an insurance company in order to avoid paying the unrelated business income tax. The employees will have reduced benefits due to the lower rate of return on investment when an insurance company, instead of the VEBA, maintains the premium stabilization reserve. The net effect of Code section 512, as amended, will be, therefore, to penalize employee payall VEBAs and provide commercial insurance companies a greater profit at the participants' expense.

The foregoing result does not appear to be what Congress intended when they attacked the abusive use of VEBAs by employers who were front loading their own contributions to VEBAs and using the contributed amounts to fund employer obligations under ERISA welfare plans, essentially tax free. Congress apparently recognized there is no abuse where contributions to a VEBA reserve are not deducted by an employer, since Code section 512(a)(3)(E)(iv) will exempt VEBAs funded by tax exempt employers from the new section 419A set-aside rules and thus will exclude a tax exempt organization's employer funded VEBA from the unrelated business income tax. The same result should follow for an employee payall VEBA since the employees' contributions are not deductible from any taxpayer's gross income.

The very purpose for which Code section 501(c)(9) was enacted was to permit VEBAs tax free accumulations of income for the purpose of providing life, sick, accident, and similar benefits. If Congress intended to deny the traditional non-abusive use of Code section 501(c)(9) by employees, Code section 501(c)(9) should have been expressly repealed rather than eviscerated by addition of a fifth subparagraph to a third paragraph of a subsection of a statute apparently aimed at VEBAs funded by employer deductions. But the statutory structure and the absence of discussion of this issue in legislative history indicate that Congress did not intend to attack non-abusive, employee payall VEBAs. If, indeed, it really was intended to tax the income of employee payall VEBAs, then the clear beneficiary is the insurance industry and the clear losers are these VEBAs' participants.

On behalf of the three VEBAs represented here today, it is recommended that a new clause (E)(v) be added to Code section 512(a)(3) to read as follows:

> (v) This paragraph shall not apply to an organization described in paragraph (9) of section 501(c) if substantially all the contributions to such organization are made by participants.

Thank you for your consideration of this matter.

Respectfully submitted,

James M. Carter

STATEMENT OF MORTON H. ZALUTSKY, ZALUTSKY, KLARQUIST AND JOHNSON, P.C., PORTLAND, OR

Mr. ZALUTSKY. Thank you, Senator. Senator Long, Senator Grassley. This morning I want to discuss funded welfare benefit plans which you recognized in the Tax Reform Act of 1984 as a potential tax shelter. You also recognized that the potential tax shelter aspects do not apply to multiemployer plans. My testimony this morning is limited to multiemployer plans which I define as a plan of more than one employer which is subject to a collective-bargaining agreement. My written testimony covers six issues. This morning I would like to discuss two issues. First, we propose that by statute you provide no limitations on the reserves for multiemployer plans. The reason is that the unique nature of the collective-bargaining process precludes abuse and requires significant reserves for these plans. There are four aspects of the collective-bargaining process which I would like to mention. First, the natural tensions of the collective-bargaining process preclude the employer from making excessive contributions. Second, the collective-bargaining agreement tends to be a multiyear contract. Therefore, these plans need reserves to (a) provide for fluctuating employment and (b) pay costs that increase during the term of the multiyear contract. Three, President Reagan has stated that the private sector must meet the social needs of the people. These plans do that by providing subsidies for retirees, widows and widowers, and disabled individuals. To the extent that you limit the contributions to these plans or impose a tax on the reserves of the plans, the plans will have less income which may then reduce the benefits that they are providing for the unemployed and the less fortunate individuals. Three, the funds once contributed by the employer never return to the employer. They are used for the benefit of all the plan's participants. In fact, the employer does not control the disposition of the funds, but the disposition is controlled by the trustees of the plan who are half-union and half management. Therefore, we propose that by statute you exempt the multiemployer plans from the reserve requirements. In fact, in the conference report you have recognized this by stating "you presume the reserves of multiemployer plans are not excessive." Therefore, we suggest that these plans not be within the ambit of the law. The second issue I will discuss relates to the statute precluding reserves for insurance premiums. Your rationale was that you did not want funded welfare plans to be a vehicle for obtaining income tax deductions for prepayment of insurance premiums. This rationale does not apply to multiemployer plans. Many multiemployer plans provide benefits through insurance and, therefore, as the statute is written, it precludes a reserve. In fact, I would point out that you cannot have a reserve for life insurance. As the statute is written, we now have a conflict with section 101 you can't have life insurance funded through an insurance company, and a participant dies and the plan pays a death benefit, then it is possible that the death benefit will be taxed as ordinary income to the individual, I am sure you do not intend this result. Thank you, Mr. Chairman.

[The prepared written statement of Mr. Zalutsky follows:]

STATEMENT OF MORTON H. ZALUTSKY, ESQ.

ZALUTSKY, KLARQUIST AND JOHNSON, P.C.
PORTLAND, OREGON

S. 814
THE TECHNICAL CORRECTIONS ACT OF 1985

COMMITTEE ON FINANCE
June 5, 1985

Re: Comments on S 814, The Technical Corrections Act of 1985

Mr. Chairman and Members of the Senate Finance Committee:

The Tax Reform Act of 1984 adopted legislation to preclude the tax shelter potential of welfare benefit plans. The two abuses with which you were concerned relate to premature income tax deductions and excessive tax-free accumulation of assets. The Tax Reform Act of 1984 adopted a statutory framework to limit these abuses by restricting an employer's income tax deductions, by taxing the income from a plan's excess reserves and by imposing a tax on a plan and/or the employer if the plan is discriminatory or provides a disqualified benefit.[1]

We suggest reconsideration of five provisions of the Tax Reform Act of 1984 and one provision of the Technical Corrections Act of 1985.

1. Permissible Welfare Plan Reserves.

The Tax Reform Act of 1984 limits the reserves for welfare benefit plans. The amount of a plan's permissible reserves is a percentage of benefits paid by the plan in the preceding taxable year. If the amount of the reserves is excessive, the employer is denied a current income tax deduction and the plan may be subject to unrelated business taxable income.

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[1] IRC sections 419, 419A, 505, 512 and 4976. All citations are to the Internal Revenue Code of 1954, as amended.

Collectively bargained plans should not be subject to the reserve limitations. It was recognized in the legislative process that collectively bargained plans are not within the ambit of the abuse which was recognized and corrected by the Tax Reform Act of 1984.[2] The adversarial nature of collective bargaining eliminates the possibility of excess contributions or excessive reserves. In addition, once funds are contributed to a collectively bargained plan, the plan's trustees control the plan's funds; the employer loses control. Finally, the plan's assets may not be returned to the employer on termination of the plan. Therefore, the "tax shelter" aspect of a welfare benefit plan does not apply to a collectively bargained plan.

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[2] "In establishing these limits, the Treasury is to presume that reserves in such plans (collectively bargained plans) are not excessive because of the arm's length negotiations between adversary parties inherent in the collective bargaining process. Because contributions under such plans are often made on the basis of a defined contribution fixed over a multiyear period on the basis of economic assumptions which prove to be incorrect and because such contributions may be the only source of benefits to be provided during layoffs, strikes, lockouts, and economic recession, these special limits are to allow substantial flexibility in determining the application of these provisions with respect to such plans." See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Prepared by the staff of the Joint Committee on Taxation (hereinafter referred to as the Blue Book), p. 786.

Many collectively bargained plans provide benefits which relieve federal and state governments of financial burdens. For example, collectively bargained plans, which we represent and of which we have knowledge, provide benefits to retirees, widows and widowers and disabled individuals. The benefits are provided at minimum or no cost to the beneficiary. Collectively bargained plans may be forced to reduce the benefits to those less fortunate individuals if the plans' assets are decreased either because of reduced employer contributions or imposition of an income tax on the plans.

A collective bargaining agreement is generally a multiyear contract. The collectively bargained plan needs significant reserves to provide for fluctuating employment over the life of the contract. Employers do not increase contributions during a contract period if employment decreases or a welfare benefit plan's costs increase. The employer's contribution is established for the contract period. When employment decreases, many plans' subsidies increase because there are more claims for disability benefits, more self payments by unemployed individuals and more early retirements. Moreover, there are generally more medical claims which increase future medical premiums.

Section 419A(f)(5) requires the Secretary of Treasury to provide higher reserve limits for collectively bargained plans. The legislative history indicates that collectively bargained plans should be given favorable treatment. The instructions to establish the reserve limits in regulations[3] are that "the Treasury is to presume that reserves in such plans are not excessive ..." (emphasis added).[4] This language indicates that the parties should be allowed to make their own agreement which presumably will not be abusive.

We suggest that Congress should clearly codify its intention to restrict the application of this legislation to plans subject to collective bargaining agreements rather than permit interpretation of its intention by regulations.[5] The proposed statutory language for section 419A(f)(5) set forth below has two aspects. First, it initially exempts collectively bargained plans from the reserve requirements and from section 512. We assume this will be the normal situation. Second, for the abnormal situation, the proposed language provides that a collectively bargained plan is subject to the reserve requirements if it is determined that the plan's reserves are unreasonable.

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[3] The regulations are to be issued by July 1, 1985.

[4] Blue Book, p. 786.

[5] It should be noted that an exemption for collectively
(Footnote Continued)

> "(5) Higher limit in Case of Collectively Bargained Plans --
>
> "(A) Notwithstanding any other provisions of this section, for purposes of sections 419 and 512, the limit determined under this section for a qualified asset account established by a welfare benefit fund maintained pursuant to one or more agreements that the Secretary of Labor finds to be collective bargaining agreements between employee representatives and one or more employers shall be no less than the amount credited to that account, if --
>
> "(i) there is evidence of good faith bargaining over funding for the benefits provided through the fund and
>
> "(ii) the Secretary does not find that the fund's reserves are unreasonable, taking into account past experience and reasonable expectations. For this purpose, an amount in a reserve attributable to employer contributions shall be deemed to be reasonable if the level of contributions required was reasonably expected to be necessary to maintain the

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(Footnote Continued)
bargained plans from the reserve limits of section 419A is consistent with the exemption for collectively bargained plans from the provisions of sections 505, 512 and 4976.

> plan of which the fund is a part, under all of the circumstances existing and anticipated at the time the collective bargaining agreement setting the contribution obligation was agreed to.
>
> "(B) For purposes of this paragraph, the term 'amount credited to that account' includes assets to provide for the future payment of any welfare benefit, within the meaning of section 419(e)(2), in addition to the benefits listed in subsection (a) of this section."[6]

2. Exceptions for 10 or More Employer Plans.

The Tax Reform Act of 1984 provides an exception from the limitation of the qualified asset account for a plan of 10 or more employers to which one employer normally does not contribute more than 10 percent of the total contributions.[7] However, these plans are subject to unrelated business taxable income.[8] The Blue Book states that these plans are similar to the relationship of insured to an insurer. This indicates that the plans are not within the ambit of abuse corrected by this legislation. Accordingly, there is no limitation on the amount of the reserves. We have two suggestions for these plans. First, the 10-percent limitation should be increased to a higher percentage such as 75 percent. Second, these plans should be exempt from the tax imposed by section 512.

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[6] This language is identical to that submitted to the Committee on Ways and Means, U. S. House of Representatives, by the National Coordinating Committee for Multiemployer Plans.

[7] Section 419A(f)(6).

[8] Technical Correction Act of 1985, section 151(a)(1) which amends section 512(a)(3)(E)(i).

3. Safe Harbor Reserves for Insured Plans.

The Tax Reform Act of 1984 authorizes the establishment of reserves by either an actuarial certification or a statutory safe harbor. The safe harbor does not allow reserves for medical insurance or disability insurance premiums.[9] The rationale to preclude insured benefits as part of the reserve is that "Congress did not intend that a fund is to be used as a vehicle for obtaining deductions for prepayment of insurance with respect to benefits."[10] Many collectively bargained plans provide benefits by insurance. It is recognized that collectively bargained plans are not within the ambit of the abuses corrected by this legislation. Therefore, collectively bargained plans should be exempt from this provision. If collectively bargained plans are not statutorily exempt from the reserve requirements, then in the alternative reserves for insurance premiums should be permitted for collectively bargained plans.

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[9] Section 419A(c)(5).

[10] Blue Book, p. 786.

4. Life Insurance.

Insurance premiums may not be permitted for the safe harbor reserves. Death benefits in excess of $5,000 provided by a welfare benefit plan not provided by life insurance may not be exempt from income tax.[11] Therefore, either the statutory safe harbor should permit reserves for life insurance or section 101 should be modified to exclude from income tax an uninsured death benefit provided by a funded welfare benefit plan.

5. Disability Benefits.

A safe harbor reserve is permitted for short-term disability.[12] Short-term disability is considered to be five months or less.[13] Many collectively bargained plans provide disability benefits for 26 weeks which is longer than 5 months. Thus, 26 weeks of disability benefits would be classified as long-term benefits. Accordingly, a reserve is precluded. We suggest that the definition of short-term disability be modified to authorize at least 26 weeks of benefits.[14]

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[11] Section 101.

[12] Section 419A(c)(5)(B).

[13] Blue Book, p. 783.

[14] It should be noted that a safe harbor reserve for

(Footnote Continued)

6. Effective Date.

The effective date to calculate the existing excess reserve is the first taxable year ending after July 18, 1984.[15] This date probably coincides with the general effective date of these provisions for noncollectively bargained plans. However, collectively bargained plans have a delayed effective date.[16] The measurement of the existing excess reserves for plans subject to a collective bargaining agreement should coincide with the application of these rules to the collectively bargained plans.

(Footnote Continued)
long-term disability is to be determined by regulation. Section 419A(c)(5)(B)(iv). Long-term disability is defined as a disability which is expected to last for at least 12 months. Blue Book, p. 783. Thus, there is a hiatus between five months and 12 months. A short-term disability could be considered any disability that is not long term. This will eliminate the hiatus.

[15] Technical Corrections Act of 1985, section 151(a)(7) amending section 419A(f)(7)(c).

[16] The effective date for plans maintained pursuant to one or more collective bargaining agreements is years beginning after the date on which the last collective bargaining agreement terminates for collective bargaining agreements in effect on July 1, 1985.

ZALUTSKY, KLARQUIST & JOHNSON, P. C.
ATTORNEYS AT LAW

MORTON H. ZALUTSKY
KENNETH S. KLARQUIST, JR.
ELAINE N. JOHNSON
MICHAEL J. BRAGG

THE WALDO BUILDING
215 S. W. WASHINGTON STREET
PORTLAND, OREGON 97204
(503) 248-0300

April 15, 1985

Mr. Harry Conaway
Office of Tax Legislative Counsel
U. S. Department of Treasury
Room 4051B
15th & Pennsylvania Avenue, NW
Washington, DC 20220

Re: IRC §§419 and 419A

Dear Harry:

On April 1, 1985, we wrote to you about funded welfare plans for collectively bargained plans. This letter is a revision of the earlier letter which you should disregard. In order to assist you in drafting the regulations for these plans, we completed a case study of a plan in the wood products industry.[1] The results of the study are startling assuming that the applicable rules for collectively bargained plans are similar to the rules for noncollectively bargained plans. The analysis will first state the facts of this plan, apply the safe harbor rules of IRC §419A(c)(5)(B) and then suggest alternatives for your consideration.

The plan is a §501(c)(9) health and welfare trust established pursuant to collective bargaining agreements. The plan covers employees who are primarily located in Oregon, Washington, California, Idaho and Alaska. There are more than 10 employers in the plan and one employer contributes more than 10 percent of the total contributions. Therefore, the plan is not subject to the exception of IRC §419A(h)(6). The contribution rates are negotiated every three years and are based on an hourly rate for each hour of service; the current rate is $1.45 per hour for non-California employees. The plan provides medical benefits, a maximum of 26 weeks of accident and sickness benefits and life insurance. As of May 31, 1984, which is the end of the plan's fiscal year, the plan's assets were approximately $32,000,000. (The plan's total assets were $32,000,000 with liabilities of approximately $7,600,000.)[2] The plan subsidizes benefits for retirees, widows, disabled individuals and terminated participants.[3] The total subsidy for retirees and

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[1] Many people are not aware of the operations of a collectively bargained health and welfare plan. Therefore, we will state the facts in great detail.

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[2] The liabilities of approximately $7,167,000 are included to calculate the amount of the qualified asset account because the liabilities include insurance premiums and are accrued for a subsequent period. Enclosed for your information are balance sheets and statements of operations for the fiscal year years 1981-1984. You will note that the plan's operating costs exceeded its income from contributions in fiscal years 1981-1983. The plan's investment income offset the loss in fiscal year 1983. However, commencing in fiscal year 1983, the trustees reduced the plan's benefits to eliminate the plan's deficit.

[3] The subsidies are as follows:

A. Disabled:

1. If a person is disabled, the plan provides six months of free coverage plus the month of return to employment and the next two months or a total of nine months. The plan's cost for this benefit is $172.99 per month.

2. If an individual remains disabled after six months, the individual may self pay $50.00 per month for 12 additional months. The plan's cost for this coverage is $199.08 per month.

3. If the individual obtains a Social Security disability award, the cost for the disabled individual and family is $38.00 per month. The plan's cost for this benefit is $102.79 per month.

B. Retiree: A retiree and spouse, who are both over age 65, pay $43.35 per month for family coverage.

C. Active Participant: An active participant who is unemployed because of a layoff, a plan closure or a

(Footnote Continued)

employees, who self pay, for the 1984 fiscal year was approximately $2,700,000.

The trustees have established a minimum reserve equal to the accrued liabilities, three months' premiums and three months' administrative expenses. If the assets decrease to an amount equal to the minimum reserve, the trustees are required to immediately meet and solve the plan's financial problems. In the last few years, the trustees have been extremely concerned about the plan's decreasing assets, reduction in employment, increased subsidies and increased insurance premiums. In 1982, the trustees projected that by approximately this time all of the plan's reserves would be consumed. The projection was erroneous because the plan earned more than anticipated because of the extraordinary high interest rates. But for the unusually high earnings, the plan would now have minimal reserves. The plan's participants have decreased from approximately 19,000 in 1981 to approximately 13,500 in December 1984. The hours worked per participant also have decreased during the same period of time by an average of six hours per month. Six hours per month per participant is an annual reduction of income of approximately $1,409,000 per year for 13,500 participants. A reduction of hours reduces the plan's income without a corresponding reduction of costs. The reason is that the cost for benefits and administration do not decrease but remain constant. In addition, premiums for medical insurance have escalated. Therefore, the trustees drastically reduced benefits during this period of time to

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(Footnote Continued)

labor dispute may self pay for a maximum of six months. There is a formula, which is based on years of service, to determine the extent of the subsidized benefit. The subsidized benefit permits an individual to pay for family coverage at the rate of $50.00 per month; the plan's cost is $199.00 per month.

D. Dissolution of marriage: The divorced noncovered spouse may self pay for six months at full premium.

E. Death: If a participant dies, the plan provides free family coverage for four months. The family may then self pay for an additional 12 months at full premium. If the deceased employee were age 55 or older, the surviving spouse may obtain retiree coverage.

attempt to match the plan's income with the plan's expenses.[4]

This plan will not be able to retain any significant reserves if the regulations for collectively bargained plans are the same as, or similar to, the safe harbor rules for noncollectively bargained plans.[5] First, the plan may have no reserves for medical benefits even though the medical premiums for the 1984 fiscal year were approximately $39,600,000. The reason is that the medical benefits are fully insured. Moreover, the safe harbor rules preclude a medical reserve for retirees. IRC §419(A)(c)(5)(B).[6] The plan's medical loss ratio for retirees was approximately 141 percent for the first nine calendar months of 1984. In addition, the plan subsidized retiree medical benefits in the approximate amount of $1,900,000 in fiscal year 1984. If the plan could maintain a safe harbor reserve, even though it were funded with insurance, the reserve based on IRC §419A(c)(5)(ii) would be approximately $13,900,000.

Second, the plan may maintain no reserves for accident and sickness benefits. A safe harbor is permitted for short-term disability. §419A(c)(5)(B). Short-term disability is considered to be five months or less. See Conference Report, CCH Pension Guide, ¶12,900. The plan provides disability benefits for 26 weeks which is longer than five months. Thus, the disability benefits are classified as long-term which precludes a reserve. However, it is possible that the regulations could provide a safe harbor reserve for the first five months of benefits.[7] If short-term disability could be defined to include 26 weeks of disability benefits, the safe harbor reserve would be approximately $232,000.

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[4] You should be aware that when employment decreases, a health and welfare plan has increased medical claims, increased disability claims and a significant increase of early retirees.

[5] We are disregarding, for purposes of this analysis, the right to maintain a reserve for administrative expenses. The total administrative expenses for the 1984 fiscal year were approximately $700,000. We are also disregarding the possibility of an actuarial certificate pursuant to §419A(c)(5)(a). An actuarial certificate is an unnecessary expense, may not project future medical cost increases (which is unrealistic) and may not be useable if a plan is insured.

[6] This is anomalous when the account limit permits additional reserves for post retirement medical benefits. §419A(c)(2).

Third, annual life insurance premiums for the 1984 fiscal year were approximately $1,462,000. Safe harbor reserves are not permissible for insured programs. Moreover, the statute does not state the percentage that may be used to calculate a safe harbor reserve for a "self insured" life insurance benefit.[8] If a reserve of 35 percent were permitted, the reserve would be approximately $512,000 and if a reserve of 17.5 percent were permitted, the reserve would be approximately $255,800.

The income tax consequences to the employers of this legislation is devastating. For fiscal year 1984, costs for benefits and administration were approximately $42,000,000; employee contributions were approximately $2,400,000 and investment income was approximately $2,500,000. Accordingly, the income tax deduction for the employers would be approximately $37,100,000 ($42,000,000 - $2,400,000 - $2,500,000).[9] However, employers contributed to the plan approximately $44,800,000. Therefore, the employers would not receive a current income tax deduction for approximately $7,700,000 ($44,800,000 - $37,100,000) of contributions. The income tax deduction would be carried over to future years. In addition, and after the expiration of the transition period, the excess reserves would result in the plan incurring unrelated business taxable income on most of the plan's earnings.[10] These income tax consequences could destroy the trust and/or exacerbate the tenuous economic situation of employers and employees in the wood products industry.

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[7] It should be noted that a related plan insures its accident and sickness benefits. Therefore, the related plan would not be able to have any reserves even if some, or all, of the benefits were considered short term. The related plan's disability benefits are similar to this plan; the related plan covers members of the same union; the related plan and this plan have eight trustees, four of whom are identical; the related plan's professional staff is identical to this plan; and the related plan and this plan have identical collective bargaining agreements relative to health and welfare benefits. Should there be different income tax consequences between these two plans merely because one plan is insured and the other plan is self insured?

[8] Query: Is it realistic to have a self-insured life insurance program? The death benefits of a self-insured plan probably would be subject to income tax and not excludable under IRC §101.

[9] For ease of presentation, we used the total gross income and not the after-tax income. §419(c)(4).

The purposes of the legislation was to preclude employers from obtaining premature income tax deductions. Conference Report, CCH Pension Guide, ¶12,900. The natural tensions in the collective bargaining process eliminates the probability of employers attempting to obtain a premature income tax deduction. Therefore, we believe that the legislation is not aimed at this type of plan. The plan needs, and similarly situated plans need, significant reserves to provide for fluctuating employment both in total employees and hours of work for each participant. When employment decreases, the plan's subsidies increase because there are more claims for disability, more self payments by unemployed individuals and more early retirements. Moreover, there are more medical claims which increase future medical premiums. Therefore, we propose that all collectively bargained plans should be exempt from the reserve requirements. If this is impossible, reserves greater than the safe harbors of §419A(c)(5) should be permitted without an actuarial certificate. Reserves should be permitted for retiree benefits and for disability benefits for a period of time longer than five months. The insurance premiums should be included in the permissible reserves. The amount of the reserves should be based on a specified number of months of projected expenses which is the current operating procedure for collectively bargained plans. We suggest that the number of months be approximately 10. The individuals who negotiate the collective bargaining agreements and operate these types of plans are generally highly intelligent, responsible and properly motivated. These individuals and their plans are not within the ambit of the abuse which Congress attempted to eliminate. Therefore, they should be permitted to control their own destiny without the imposition of a devastating income tax.

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[10] Assuming the plan's assets remain approximately the same, all plan earnings up to approximately $31,768,000 ($32,000,000 - $232,000 the safe harbor reserve for disability) would be taxable to the plan.

Previously, we discussed this issue with Senator Packwood, John Colvin and Bill Lieber. They each suggested that we write to you and send them copies of our letter. Accordingly, we are sending them copies. If you wish to discuss this topic, or any related matter, please contact our office. You should be aware that I will not be available in May.

Very truly yours,

ZALUTSKY, KLARQUIST & JOHNSON, P.C.

Morton H. Zalutsky

MHZ:ksg
c: All Trustees
Senator Bob Packwood
Mr. John Colvin
Mr. William M. Lieber
Mr Patrick A. Toohey
Mr. Brad Byers
Mr. Phil Harris
Mr. Mike Salsgiver

Balance Sheet
May 31, 1982 and 1981

ASSETS

	1982	1981
Cash in bank	$ 249,406	32,798
Receivables:		
Employer contributions	2,827,921	3,284,706
Accrued interest	460,685	682,314
Total receivables	3,288,606	3,967,020
Investments, at market:		
Short-term investments	3,672,977	3,330,000
Corporate bonds	2,435,183	5,188,201
U.S. Government securities	15,667,922	17,694,041
	21,776,082	26,212,242
	$ 25,314,094	30,212,060

LIABILITIES, RESERVES AND FUND BALANCE

	1982	1981
Liabilities:		
Withheld F.I.C.A.	$ 41,053	-
Premiums payable	6,655,228	6,552,119
Experience deficit payable	-	1,398,008
Due incurred claims reserve (note 6)	891,002	-
Accident and sickness claims payable	316,827	381,093
Unapplied self-pay deposits	153,339	143,390
Administrative expenses payable	9,016	6,524
Total liabilities	8,066,465	8,481,134
Reserve and fund balance (note 3):		
Retrospective premium reserves	1,097,989	1,221,126
Total and permanent disability reserve	3,687,000	3,157,500
Incurred claims reserve - hospital and medical	-	525,000
Incurred claims reserve - life	186,942	226,687
Formulated reserve	10,050,000	10,250,000
Fund balance	2,225,698	6,350,613
Total reserves and fund balance	17,247,629	21,730,926
	$ 25,314,094	30,212,060

See accompanying notes to financial statements

Statement of Operations
Years ended May 31, 1982 and 1981

	1982	1981
Revenues:		
Employer contributions	$ 34,249,671	37,281,944
Employee self-payments	1,405,242	1,286,017
	35,654,913	38,567,961
Cost of benefits:		
Premiums	39,607,907	38,322,121
Claims	1,663,323	1,970,518
Medicare reimbursement	5,641	4,140
	41,276,871	40,296,779
Experience deficit - net (note 5)	1,253,159	314,840
Incurred claims reserve (note 6)	891,002	-
	43,421,032	40,611,619
Excess of benefits over revenues	(7,766,119)	(2,043,658)
Administrative expense:		
Administrative fees	360,565	357,420
Investment counsel and custodial fees	37,019	73,528
Legal	20,254	21,267
Audit	8,901	8,824
Payroll audits	-	752
Claims audit	-	23,552
International Foundation dues	325	-
Trustee travel and meeting	11,204	5,331
General meeting expense	9,776	5,367
Fidelity bond and insurance	504	510
Trustees protective liability insurance	5,480	8,483
NSF checks (refunds)	(112)	868
Data processing programming	2,514	31,397
Postage, mailing and miscellaneous	247	3,359
Total administrative expense	456,677	540,658
Excess (deficiency) of contributions over benefits and administrative expenses	(8,222,796)	(2,584,316)
Other income:		
Interest	2,911,617	2,664,136
Realized gain (loss) on sales of securities	59,013	(10,017)
Unrealized gain (loss) on investments	768,869	(1,038,265)
Total other income	3,739,499	1,615,854
Excess of expense over revenue	$ (4,483,297)	(968,462)

See accompanying notes to financial statements

Statement of Reserves and Fund Balance
Years ended May 31, 1982 and 1981

	1982	1981
Balance beginning of the year	$ 21,730,926	22,699,388
Excess of expense over revenue	(4,483,297)	(968,462)
Balance end of the year	$ 17,247,629	21,730,926

See accompanying notes to financial statements

Balance Sheet
May 31, 1983 and 1982

ASSETS

	1983	1982
Cash in bank	$ 52,240	249,406
Receivables:		
Employer contributions	3,181,294	2,827,921
Accrued interest	523,753	460,685
Experience refund (note 5)	399,254	-
Total receivables	4,104,301	3,288,606
Investments, at market:		
Short-term investments	3,705,850	3,672,977
Corporate bonds	10,709,905	2,435,183
U.S. Government securities	6,453,595	15,667,922
	20,869,350	21,776,082
	$ 25,025,891	25,314,094

LIABILITIES, RESERVES AND FUND BALANCE

	1983	1982
Liabilities:		
Administrative expenses payable	$ 10,928	9,016
Withheld F.I.C.A.	-	41,053
Premiums payable	6,392,798	6,655,228
Experience deficit payable	42,179	-
Due incurred claims reserve (note 6)	-	891,002
Accident and sickness claims payable	241,899	316,827
Unapplied self-pay deposits	146,656	153,339
Total liabilities	6,834,460	8,066,465
Reserve and fund balance:		
Retrospective premium reserves (note 3)	2,120,204	1,097,989
Total and permanent disability reserve (note 3)	3,996,750	3,687,000
Incurred claims reserve - life (note 3)	178,536	186,942
Formulated reserve (note 4)	10,170,000	10,050,000
Fund balance	1,725,941	2,225,698
Total reserves and fund balance	18,191,431	17,247,629
	$ 25,025,891	25,314,094

See accompanying notes to financial statements

Statement of Operations
Years ended May 31, 1983 and 1982

	1983	1982
Revenues:		
Employer contributions	$ 35,850,402	34,249,671
Employee self-payments	1,769,782	1,405,242
	37,620,184	35,654,913
Cost of benefits:		
Premiums	38,319,324	39,607,907
Claims	1,235,273	1,663,323
Medicare reimbursement	5,840	5,641
	39,560,437	41,276,871
Experience deficit - net (note 5)	705,051	1,253,159
Incurred claims reserve (note 6)	(633,395)	891,002
	39,632,093	43,421,032
Excess of benefits over revenues	(2,011,909)	(7,766,119)
Administrative expense:		
Administrative fees	436,486	360,565
Investment counsel and custodial fees	43,048	37,019
Legal	17,745	20,254
Audit	8,875	8,901
Payroll audit	382	-
Hospital audit	16,820	-
International Foundation dues	325	325
Trustee travel and meeting	10,888	11,204
General meeting expense	7,480	9,776
Fidelity bond and insurance	1,595	967
Trustees protective liability insurance	4,767	5,017
NSF refunds	(88)	(112)
Data processing programming	9,076	2,514
Postage, mailing and miscellaneous	1,907	247
Total administrative expense	559,306	456,677
Excess of benefits and administrative expenses over contributions	(2,571,215)	(8,222,796)
Other income:		
Interest	2,132,502	2,911,617
Realized gain on sales of investments	865,579	59,013
Unrealized gain on investments	518,936	768,869
Total other income	3,515,017	3,739,499
Excess (deficiency) of revenue over expense	$ 943,802	(4,483,297)

See accompanying notes to financial statements

Statement of Reserves and Fund Balance
Years ended May 31, 1983 and 1982

	1983	1982
Balance beginning of the year	$ 17,247,629	21,730,926
Excess (deficiency) of revenue over expense	943,802	(4,483,297)
Balance end of the year	$ 18,191,431	17,247,629

See accompanying notes to financial statements

Balance Sheet
May 31, 1984 and 1983

ASSETS

	1984	1983
Cash in bank	$ 61,341	52,240
Receivables:		
Employer contributions	4,000,355	3,181,294
Accrued interest	486,023	523,753
Experience refund	-	399,254
Total receivables	4,486,378	4,104,301
Investments, at market (notes 1 and 3):		
Short-term investments	7,653,135	3,705,850
Corporate bonds	9,603,700	10,709,905
U.S. Government securities	10,246,759	6,453,595
	27,503,594	20,869,350
	$ 32,051,313	25,025,891

LIABILITIES, RESERVES AND FUND BALANCE

	1984	1983
Liabilities:		
Administrative expenses payable	$ 38,564	10,928
Premiums payable	7,129,032	6,392,798
Experience deficit payable	-	42,179
Accident and sickness claims payable	244,359	241,899
Unapplied self-pay deposits	244,103	146,656
Total liabilities	7,656,058	6,834,460
Reserve and fund balance:		
Retrospective premium reserves (note 4)	1,338,457	2,120,204
Total and permanent disability reserve (note 4)	4,043,250	3,996,750
Incurred claims reserve - life (note 4)	146,826	178,536
Formulated reserve (note 5)	11,490,000	10,170,000
Fund balance	7,376,722	1,725,941
Total reserves and fund balance	24,395,255	18,191,431
	$ 32,051,313	25,025,891

See accompanying notes to financial statements

Statement of Operations, Reserves and Fund Balance
Years ended May 31, 1984 and 1983

	1984	1983
Revenues:		
Employer contributions	$ 44,804,476	35,850,402
Employee self-payments	2,385,072	1,769,782
	47,189,548	37,620,184
Cost of benefits:		
Premiums	41,761,911	38,319,324
Claims	1,328,614	1,235,273
Medicare reimbursement	4,317	5,840
	43,094,842	39,560,437
Experience deficit (refund) - net (note 6)	(1,654,643)	705,051
Incurred claims reserve (note 7)	(125,070)	(633,395)
	41,315,129	39,632,093
Excess (deficiency) of revenues over expenses	5,874,419	(2,011,909)
Administrative expenses:		
Administrative fees	438,974	436,486
Investment counsel and custodial fees	72,932	43,048
Legal	20,567	17,745
Audit	8,450	8,875
Payroll audit	1,475	382
Hospital audits	129,659	16,820
International Foundation dues	325	325
Trustee travel and meeting	13,384	10,888
General meeting expense	8,398	7,480
Fidelity bond and insurance	669	1,595
Fiduciary insurance	4,517	4,767
NSF checks (refunds)	629	(88)
Data processing programming	-	9,076
Postage, mailing and miscellaneous	3,554	1,907
Total administrative expense	703,533	559,306
Excess (deficiency) of contributions over benefits and administrative expenses	5,170,886	(2,571,215)
Other income:		
Interest	2,308,257	2,132,502
Realized gain on sales of investments	187,097	865,579
Unrealized gain (loss) on investments	(1,462,416)	518,936
Total other income	1,032,938	3,515,017
Excess of revenues over expenses	6,203,824	943,802
Balance - beginning of the year	18,191,431	17,247,629
Balance - end of the year	$ 24,395,255	18,191,431

See accompanying notes to financial statements

The CHAIRMAN. Mort, let me ask you this question. Last year, the VEBA rules were enacted on the argument of Treasury that we were having too much buildup, too much advance funding.

Mr. ZALUTSKY. Correct.

The CHAIRMAN. Tell me again why that is not likely to happen with collective bargaining plans as opposed to individual plans, especially collective bargaining multiemployer plans.

Mr. ZALUTSKY. Is my time limited for the answer?

The CHAIRMAN. I have 5 minutes to ask questions, and you have got to fit your answer within my 5 minutes, so go ahead.

Mr. ZALUTSKY. OK. Here is how a single employer plan advance is funded. Let's take a calendar year taxpayer—December 31. The taxpayer would set up a VEBA with a November 30 fiscal year. On December 1, the employer would contribute to the plan the full premium for the ensuring year, which would go from December 1—let's use December 1, 1985—through November 30, 1986, thereby getting a year's income tax deduction for the corporation for the year ending December 31, 1985. The multiemployer plan does not do that. We don't have advanced funding because, first, the employers do not want to contribute more to the plan. They want to reduce their cost, reduce the payments to the plans, and therefore, the natural tensions preclude an excess reserve.

The CHAIRMAN. You are saying the employers make their contributions on a weekly basis, a monthly basis, whatever it may be.

Mr. ZALUTSKY. That is right. Second, the contribution is made on a unit basis—per hour, per ton of coal—and therefore, they do not fund a year in advance. Third, in a single employer VEBA, if there are excess reserves in the plan at the end of the year, the excess reserves inure to the benefit of that employer, but in a multiemployer plan, once the funds are contributed, the funds cannot go back to that employer. In fact, if the employer has a number of employees in year one and in year three has few employees, any excess does not go to the contributing employer's employees. It goes to other employers' employees. And therefore, there is no incentive to use a multiemployer VEBA as a tax shelter.

The CHAIRMAN. You haven't got any Treasury regulations issued yet on the multiemployer plans on collective bargaining. How are you planning? What are you doing?

Mr. ZALUTSKY. That is a good question, Senator. The regulations are supposed to be issued by July 1. They have not come out. The prospects are that they will not come out, and we are in a quandry.

The CHAIRMAN. What are you going to do?

Mr. ZALUTSKY. Pray.

[Laughter.]

The CHAIRMAN. That is as good as many of the policies we have today. I have no other questions.

Mr. ZALUTSKY. Senator Packwood, as you stated, we do not have the regulations and the prospects are that we will not have them by July 1, 1985. Multiemployer VEBA's desperately need guidance in this complex area of the law. Therefore, it would be very helpful to have immediate passage of legislation which would exempt these plans from all of the funded welfare plan provisions of the Tax Reform Act of 1984.

The CHAIRMAN. Senator Grassley?

Senator **Grassley**. Thank you, Mr. Chairman I don't have a question, but I do want to commend to the chairman and to the rest of the committee Mr. Wood's testimony in which he asks for rural electric properties or nonprofit organizations generally to have parity with other organizations that can have 401(K) plans, and it is because of an ambiguity in the existing law that prevents that. And I think that, since there is an ambiguity to clear up and there is no revenue loss, I would hope that we could include this in the technical corrections amendment. We have several cosponsors on the amendment, and it is just a matter of getting employees of organizations like REC's the same sort of plans that, for instance, public utility employees can have.

The **Chairman**. I just want to make sure, Chuck, that on this technical corrections bill we hold it to that, rather than correcting intentional mistakes we made last time. We may have made bad judgment, but if we knew what we were doing, I don't want to start correcting it on this bill because then we are going to get into an argument about whose bad judgment was bad judgment and whose judgment was good and should we correct it now.

Senator **Grassley**. Would I not be right, though, that if it was an honest oversight, that would fit into that category?

The **Chairman**. I am not even sure an honest oversight would be the correct interpretation. What we are trying to do is change errors that we made that are errors. Oversight is one thing. Errors are another. There may have been 100 things we overlooked last time.

Senator **Grassley**. It would fall under the fact that we had evidence that we were trying to include almost everybody, and somehow some organization got left out.

The **Chairman**. Yes, inadvertently got left out. That would be a technical correction.

Senator **Grassley**. I hope that is what we can prove. I think we can.

The **Chairman**. I have the same empathy for the rural co-ops that you do because I have a fair number as you do in your State—I think we all do in our States—but I like to think we have a great many more. I don't know if we do disproportionately, but we certainly have a lot of them.

Senator **Grassley**. Thank you.

The **Chairman**. Senator Long?

Senator **Long**. No questions, Mr. **Chairman**.

The **Chairman**. Senator Moynihan?

Senator **Moynihan**. No questions, Mr. **Chairman**.

The **Chairman**. Gentlemen, thank you very much. Mort, good to see you again.

Mr. **Zalutsky**. Thank you, Senator.

The **Chairman**. Now, let's move onto a panel of Marjorie O'Connell, William Chip, Cecil Ray, Russell Barnes, and Donal Milroy. I am going to ask Mr. Barnes to speak first because Senator Moynihan is here specifically to hear that testimony, and he has to go back to another committee.

STATEMENT OF RUSSELL BARNES, SENIOR VICE PRESIDENT AND CHIEF OPERATING OFFICER, PAN AM WORLD SERVICES, INC., NEW YORK, NY

Mr. **Barnes**. Thank you, Mr. Chairman. I am Russell Barnes, Senior Vice President of Pan Am World Services. I have with me William Evans, our Vice President of Government Relations, and Mr. Ron Smith, who represents the employees of our corporation. The Tax Reform Act of 1984 provides new rules concerning fringe benefits. It sanctions a long-standing airline practice of providing standby flight benefits to employees of airlines without taxation. However, the new rules impose a new requirement, that is, that to receive the tax-free standby benefits, the employee must be in the "line of business." For many years, Pan Am has maintained divisions devoted to support service work. This work includes airline service, aircraft maintenance, airport operation and maintenance, and aerospace O&M operations throughout the United States and overseas. The company has about 7,500 employees. Most of these employees continue to be employees of Pan Am. However, there is a question now about the line of business rule for these employees. It could be argued that they are not in the line of business, and because of the uncertainty surrounding this matter, Pan Am regretfully cancelled the standby flight benefits for these employees, effective December 31, 1984. The employees of Pan Am World Services have made career decisions with the company, based on the availability of standby flight benefits. Employees have freely transferred in and out of the airline between the company's divisions and between Pan Am World Services. Now, these people can't move back to other jobs in the airline to reestablish their benefits because the company is in financial straits, as you probably know, due to cutbacks and retrenchment. Retirees are hit especially hard. People that have been with the company 30 years or more find themselves immediately devoid of the benefit that they had counted on all their life. Our foreign employees are seriously hurt. Many of these employees have children in school, both in foreign countries or in the United States, the foreign based employees are not able to get back to be with their families. Some of these folks have spent or are having to spend their entire savings in order to pay for travel that would have been available to them. Senator Moynihan has introduced a bill, S. 120, to correct this problem. There are over 20 sponsors in the Senate and 5 on this committee. We support that bill. Only individuals employed before 12 September 1984 would be eligible tax free standby flight benefits. The benefit would phase out through attrition because employees hired after 12 October 1984 would no longer be eligible. Pan Am can't solve this problem by resorting to the excise tax under Code 4977. The cost of doing so would be prohibitive and would far exceed the cost of the benefits that would be available to the people. So, Mr. Chairman, we urge that you include in the Technical Corrections Act of 1985 a provision that will permit Pan Am to restore tax-free standby travel to World Service employees hired prior to 12 September 1984. Thank you.

[The prepared written statement of Mr. Barnes follows:]

Statement of
Russell M. Barnes
Senior Vice President and Chief Operating Officer
Pan Am World Services, Inc.
on H.R. 1800
before the
Committee on Ways and Means
U.S. House of Representatives

May 16, 1985

Mr. Chairman, I am Russell M. Barnes, Senior Vice President and Chief Operating Officer of Pan Am World Services, Inc. I would like to thank you and the Committee for affording me the opportunity to testify today on the need to make technical corrections to the Tax Reform Act of 1984 to restore tax-free standby flight benefits to World Services employees. Accompanying me today, Mr. Chairman, is Peter Dugre, our General Counsel. Also accompanying me are James O'Brien and Harry James, who are respectively a World Services retiree and a World Services employee stationed overseas. These last two individuals are among those seriously affected by unavailability of tax-free flight benefits.

I have prepared a detailed written memorandum regarding the necessary amendment, and I request that that memorandum be included in the record. Our unions support the amendment and, I understand they will be submitting written statements for the record. I would now like to address briefly the high points.

The proposal we support has been introduced by Mr. Stark as H.R. 528. It has over 80 sponsors in the House, including 15 on this Committee.

The Tax Reform Act of 1984 provides new rules governing fringe benefits, effective January 1, 1985. These rules expressly sanction the long-standing practice of the airline industry to provide no-additional-cost services, such as standby flight benefits, to employees without taxation. However, the 1984 Act imposes a requirement that, to be eligible for this tax-free treatment, the employee must be employed in the same "line of business" as that in which the service is provided. For example, an employee of an airline could receive standby flight benefits on a tax-free basis only if he is employed in the airline line of business, not if he works in a hotel which is owned by the airline.

For many years, Pan American World Airways, Inc., has maintained an affiliate, World Services, which performs airline, airport, aerospace and related services for others on a contract basis. Most of the World Services employees are or were on the Pan Am payroll but have been detailed to World Services. These employees arguably may not be in the airline "line of business," and Pan Am regretfully terminated their standby flight benefits when the 1984 Act took effect. H.R. 528 would waive this "line of business" restriction with respect to World Services for persons employed on or before September 12, 1984.

Many employees of World Services chose that company (or Pan Am, from which they are on detail) years ago because nontaxable standby air travel benefits were materially important to them. For decades, significant career and personal decisions have been made based upon continued eligibility for these benefits. Many of the World Services employees, in fact, have formerly performed services for Pan Am but were detailed to the subsidiary without any contemplation that their ability to use standby air travel benefits would be endangered. These individuals are now in a position where they cannot move on to comparable employment elsewhere or replace these benefits.

This is especially true of retirees, who are irreparably injured. For example, an individual who worked for Pan Am in the airline line of business for 30 years, then accepted transfer at Pan Am's request to World Services for a few months, and retired in 1983 would be ineligible for tax-free standby flight benefits because he would not be a Pan Am retiree. This is so even though the 1984 Act was passed after he retired. Similarly, an individual with many years of service to Pan Am, but who is now on detail to World Services, would also be denied retiree benefits in the future, as well as current benefits while he works for World Services.

Also unexpectedly and irreparably harmed are employees who accepted foreign assignments before the 1984 Act in anticipation of using their flight benefits to send their children to schools in the United States or return home themselves to visit their families during the time they are assigned overseas. Without standby flight benefits, these employees are burdened by substantial costs unanticipated at the time they accepted their assignments.

The proposal is narrowly tailored to provide relief only to those entitled to it. Only individuals employed on or before September 12, 1984, would be benefited. Subsequently hired employees would not be eligible. Moreover, over the course of time, the benefited group will decrease in size through attrition. In this regard, the proposal is much more limited in scope than the accommodation made in the 1984 Act for nonretail employees entitled to retail store discounts. The retail store rule applies to all employees of an affiliate, including future employees, as long as employees of the affiliate were entitled to an employee discount on October 5, 1983. Thus, the retail store rule will continue in force indefinitely. Pan Am's proposal, in contrast, is self-limiting and will phase itself out automatically through attrition of the group of covered employees.

Pan Am cannot solve the problem of its World Services employees by electing to be subject to the excise tax under Code section 4977. The 1984 Act provides that the "line of business" limitation may be waived if the employer elects to be subject to this tax. The tax is based on the value of no-additional-cost services and qualified employee discounts provided to all employees of the Pan Am group, including those working in the airline line of business, retirees, and dependents. Pan Am has some 30,000 employees, while World Services has only about 7,500. The excise tax imposed, should the election be made, would far exceed the entire value of the travel provided to World Services employees.

In this regard, the excise tax mechanism plainly is technically deficient. Because the excise tax takes into account the value of benefits to all employees, including those who are in the airline line of business and concededly are entitled to exclude the value of the benefits from income, the tax would be totally out of proportion to the benefits made available to employees outside the airline line of business. The excise tax mechanism is especially ill-suited to companies like Pan Am, the bulk of whose employees may receive nontaxable benefits without the election. In contrast, an employer which had only a low proportion of employees who qualified for benefits under the appropriate line of business could elect to extend benefits to his other employees at a relatively lower additional cost.

Quite apart from the economic burdens described above, which Pan Am cannot afford, an election to be subject to the excise tax would impose a serious administrative burden on Pan Am. Moreover, correct valuation of employees' special low-priority standby status is certain to present many difficult issues and may result in protracted audit disputes between Pan Am and the Internal Revenue Service, neither of which organizations should be asked to devote scarce resources to those matters.

Mr. Chairman, all of the employees of World Services join with me in urging you to include in the Technical Corrections Act of 1985 a provision to permit employees who worked for World Services on or before September 12, 1984 to continue to be eligible for standby air travel benefits on a tax-free basis.

Statement of
Harry James
Base Manager, Antigua
Pan Am World Services, Inc.
on H.R. 1800
before the
Committee on Ways and Means
U.S. House of Representatives

May 16, 1985

My name is Harry James and I am 57 years of age. For the past 27 years I have worked for Pan American World Airways. Since 1979 I have been detailed to Pan Am World Services on a contract to operate and maintain downrange tracking stations on the U.S. Air Force Eastern Test Range. This Range extends from Cape Canaveral to the remote island of Ascension in the south Atlantic Ocean. I am presently the Base Manager at the tracking station on Antigua.

I am proud to have participated in a program that was of national interest and which would open a new era for the airline industry of tomorrow with flights into space and to other planets. During all these years of hardship on remote islands and separation from my family due to unavailability of adequate housing and limited schooling for my three children, I relied upon the two or three times a year I could return home to my wife, parents, and children utilizing my standby travel benefit privilege. In addition, like many other fellow employees, I was relying upon standby travel benefits after retirement for my wife and I. The Deficit Reduction Act resulted in the elimination of standby travel benefits for myself and employees similarly situated and created unforeseen problems to all those who made career decisions and sacrifices for many, many years. I do believe that the effect the Deficit Reduction Act created was unintentional; therefore, I plead with you, for fairness sake, to approve the proposed amendment that would provide relief and return these benefits at least to those employees who were on the Company's payroll on or before September 12, 1984.

Statement of
James E. O'Brien
Retiree
Pan Am World Services, Inc.
on H.R. 1800
before the
Committee on Ways and Means
U.S. House of Representatives

May 16, 1985

My name is James E. O'Brien and I currently reside in Florida. I'm now retired but worked for Pan American World Airways for 35 years. The first 12 years, beginning in late 1946, I operated a Ground Control Approach radar for the airline at Gander, Newfoundland. Then in early 1959 I was transferred to Pan Am's Guided Missiles Range Division at Cape Canaveral as an Aircraft Controller. Subsequently, I was promoted to a Test Operations Controller. In this job I was responsible for calling up all Range resources in support of missile tests, including the manned Mercury and Gemini programs. In 1979, I was detailed to Pan Am World Services and in May of 1981 I retired at age 66.

This law was passed three years after I retired. I had no way to know when I accepted my World Services' assignment, after so many years with Pan American, that my family and I would be affected so adversely.

Reduced fare standby travel privileges were an important consideration in my staying with Pan Am over the years. We traveled extensively because of family medical problems while I was still working. Since I have retired, my wife and I travel to visit our children who are located in this country and Canada. My plans for the future included such trips. However, without standby travel benefits, our finances now make this quite impossible. Further, we certainly would not have planned our retirement home so distant from our children. I had no idea that this important benefit for which I had been eligible would suddenly become taxable and be taken from me. In fairness, I ask you to make it possible for my family and I to receive my retirement benefits.

Written Statement of
Ron Smith
Facility Shops Foreman
Cape Canaveral Air Force Station, Florida
Pan Am World Services, Inc.
on S. 814
Committee on Finance
United States Senate

June 5, 1985

My name is Ron Smith. I have been employed by Pan American World Airways and stationed at the United States Air Force Eastern Test Range since July, 1956. During these last 29 years it has been my privilege and pleasure to work as part of, and to witness, our country's space program. I have been involved with both Air Force and NASA projects. Pan American and its affiliate, Pan Am World Services, have served as prime contractor on the range for over 30 years.

My family and I have enjoyed standby flight benefits for this entire period of time. In recent years these benefits have been especially important to us, as they have enabled us to maintain close contact with our oldest son and his family who serve with the United States Air Force in Zaragoza, Spain. Last November, my wife and I were able to join my son for the Thanksgiving holiday while he was on TDY and away from his family.

Many of my co-workers at the Cape, other projects, and retirees have situations similar to mine. All of us, at one time or another, have made significant career decisions based on these standby flight benefits. We have planned our retirement based upon these privileges. I know our friends who have completed their careers and retired are bitterly disappointed to be without a benefit they have relied upon, and now have lost due to the language of The Deficit Reduction Act of 1984.

My fellow employees, retirees and I urge you to join with Senator Moynihan and other co-sponsoring colleagues to quickly remedy this injustice by passing the provisions of S. 120 as part of S. 814.

Senator MOYNIHAN. Mr. Chairman, could I just make a few remarks. I am sorry that I have to be elsewhere this morning. We have as cosponsors of our bill Senators Bentsen, Durenberger, Symms, Boren, and Heinz.

The Tax Reform Act of 1984 maintains the nontaxable status of certain services provided to employees, including the traditional practice by airlines of providing free or reduced cost standby air travel to their employees. The recent tax legislation, however, stipulated that these flights benefits may be offered only to employees in the airline line of business. The so-called line-of-business rule was adopted to prevent conglomerates from providing employees another line, such as car rentals.

The new rules have had an unforseen and unintended effect on many employees of Pan Am World Services, Inc. Many of them were employees of Pan American World Airways, Inc., and were transferred to Pan Am World Services, fully expecting that their flight benefits, long considered part of their compensation, would remain nontaxable. While Pan Am World Services, Inc., does not itself operate an airline, as the current line-of-business rule would require, its employees are directly involved in the airline's operation, in the maintenance and servicing of airplanes, airports, and aerospace facilities. The intent of the line-of-business rule, as I understood it when it was introduced in the Finance Committee, was to discourage large conglomerates from providing employees excessive amounts of nontaxable compensation, not to withhold traditional benefits from the employees of Pan Am World Services.

Many of these employees, I would add, are stationed abroad. They accepted such assignments with the understanding that their standby air travel benefits would provide them ready means to occasionally return to their homes in the United States. I also would mention that many of these employees are working under contracts with the Federal Government, operating airfields and communications systems around the world where there are no regional facilities available to our armed services. They are doing important work, often under disagreeable or dangerous circumstances. These employees have always shared the same tax-free flight benefits that Pan American Airways employees have enjoyed; now, a technicality in the 1984 tax law will take them away.

Mr. Chairman, this legislation would provide a narrow extension of the line-of-business rule to cover Pan Am World Services, Inc., employees, and applies only to persons emplolyed as of September 12, 1984. This rule would protect only those who had legitimately anticipated continued nontaxable standby air travel benefits, not new employees.

The CHAIRMAN. Thank you. Ms. O'Connell?

STATEMENT OF MARJORIE A. O'CONNELL, O'CONNELL & KITTRELL, WASHINGTON, DC

Ms. O'CONNELL. Good morning, Senator Packwood and members of the committee. Thank you for the opportunity to testify about Senate 814, the Technical Corrections Act. My remarks are confined to those provisions of the Tax Reform Act that have to do with domestic relations tax reform, a part of the simplification title in the original act, While I might testify about all of the technical problems, I am mindful of your concern that where judgments were made which may prove wrong in the operation, that is not what this bill is supposed to be about. So, before the red light goes on, I would just like to tick off all of those problems where I think genuinely an error was made in drafting this, which is causing us severe difficulties in the field. And I will do them in the order of greatest difficulties which we are having. The first which I would commend to your changing is an amendment which would change section 71(B)(1)(b) of the Internal Revenue Code. That provision currently states that, in order for an alimony payment to be tax deductible, the document which provides for the payment—and that includes perhaps a court order or a temporary support order of a court—must literally state that the payments terminate at the payee's death. Senator, in every State, payments under State law automatically terminate at the payee's death. Thus, we have a Federal tax law requirement to restate a part of the State code. Whether it is a judge that forgets to do so, counsel that doesn't realize one should do so, or parties who probably ought to be free to sit down across a table and try to reach their own understanding and commit it to writing about support payments, they probably shouldn't be made to repeat what is in their State law. It is a duplicative, unnecessary requirement. Particularly where it applies to temporary support orders, there is a serious problem. The temporary support order is most often issued with no counsel in the room, with one party before the court—not all the parties—from a bench which is usually not as technically proficient in the tax law as many of us may be, with the result that the order is a preprinted form so that many cases may be dealt with quickly. Those preprinted forms don't have these magic words and probably shouldn't be required to do so.

The second change I would commend to you in my oral testimony is in section 71(f)(1) where there is a requirement that payments to be deductible have to be contingent only upon the death or remarriage of the payee or the death of the payor. The temporary regulations, I think, have expanded correctly as Congress intended that contingency requirement to allow that any contingency that hasn't actually occurred is a sufficient contingency to let the payments be deductible. If the literal interpretation of the statute were the case, once again any court ordered payments, as opposed to any payments agreed to by the parties, could never be deductible by the payor. Thus, the bench, every time it had to act, to craft a support package, would put people in a less economically advantageous situation when it crafts a package.

I am certain that the unintended result is that the well-to-do who can always find counsel to craft an agreement for them will have deductible alimony, and the not so well-to-do, who very often have to present themselves to a judge to have deductible alimony, won't ever be able to get it under the statute. So, consequently, for those reasons, I commend especially those two changes and also all of the others that are in my written testimony, which I hope you will accept for the record. Thank you.

The CHAIRMAN. Thank you. Mr. Chip?

[The prepared written statement of Ms. O'Connell follows:]

Committee on Finance
Hearing on S. 814, Technical Corrections Act of 1985
June 5, 1985

Testimony of Marjorie A. O'Connell
O'Connell & Kittrell
Washington, D.C.

Outline of Testimony.

I. The domestic relations provisions of the Tax Reform Act of 1984 require technical amendments because of drafting inconsistencies and problems which have arisen under various state laws.

II. Under Section 71(b)(1)(D), the requirement that a divorce or separation instrument must state that the alimony liability ends at the payee's death should be deleted or, in the alternative, should not apply to temporary support orders.

III. Under Section 71(f)(1), the requirement that a payments may be contingent only on the death of either spouse or the remarriage of the payee should be amended to state its intended standard which is found in the Temporary Regulations. Temporary Regulation Section 1.71-1T, Q/A 23, provides that any contingency other than the passage of time is ignored until that contingency occurs.

IV. Under Section 71(f)(5)(C), the time period for payments under the exception to the recomputation rules should be the six post-separation year period used for other recomputation purposes.

V. For purposes of Section 2516, the definition of "husband" and "wife" in Section 7701(a)(17), which includes former spouses, should be applied for those Section 2516 cases when agreements are signed after the divorce.

VI. Under Section 6013(e), the innocent spouse provisions in the Tax Reform Act are unnecessarily complicated. The test of "no basis in fact or law" is vague and harsh. The complicated mechanics of the percentage tests in Section 6013(e)(4) are not reasonably related to the purpose of the statute and should be modified.

I. Introduction.

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear at this hearing to testify about S. 814, the Technical Corrections Act of 1985. My name is Marjorie A. O'Connell and I am a tax attorney in Washington, D.C. with the firm of O'Connell & Kittrell. I am the author of Divorce Taxation, published by Prentice-Hall, Inc. My testimony today is about the domestic relations taxation provisions of the Tax Reform Act of 1984.

The Tax Reform Act of 1984 made the most significant changes in the domestic relations provisions of the Internal Revenue Code since the enactment of the alimony deduction in 1942. The Act completely revised the divorce tax law about alimony, property settlements, dependency exemptions, gift and estate taxation, and the innocent spouse rules applicable to joint returns. The new alimony rules under Section 71 have proven particularly difficult for domestic relations practitioners to understand and use for their clients. Since the passage of the Tax Reform Act, I have spoken at more than 20 seminars about the new divorce tax rules. My recommendations today include the comments and concerns of attorneys across the country with whom I have worked. Although many of these concerns would require substantive changes, I will limit my testimony solely to technical corrections.

II. Section 71(b)(1)(D): Payments must terminate at the payee's death.

The thrust of the new provisions of Section 71 is to impose objective requirements to determine which payments are taxable as alimony. One of the principal requirements is that the payments must terminate at the death of the payee. This is a reasonable test to distinguish payments for support from payments in respect of property.

The Conference Committee on the Tax Reform Act added a parenthetical clause which requires that the divorce or separation instrument state that there is no liability to pay after the payee's death. This clause has and is continuing to cause grave problems. If this "magic language" is not in the instrument, none of the payments qualify as alimony. This requirement catches the persons who try to resolve their divorce or separation without legal assistance and those represented by counsel who do not know the "magic words". The purpose of the statute is not served by imposing such a highly technical requirement on these parties. Under state law, spousal support payments automatically terminate on the death of the recipient, unless special provision is made for continuation of the payments. Section 71 disregards this state law and sets up its own technical duplicative test.

The second principal area in which this requirement is causing problems is for temporary support orders. In many jurisdictions, temporary support orders are entered on preprinted forms on which a judge merely enters the names of the parties and the amount to be paid. None of these forms printed before 1985 would meet the statute's requirement. While these forms will be changed eventually, there are many taxpayers who will make payments under pre-1985 forms with erroneous expectations of the tax results. Whenever possible, the Code should try to match taxpayers' reasonable expectations to promote better compliance.

I recommend that the parenthetical clause at the end of Section 71(b)(1)(D) be eliminated. If the clause is not eliminated, the clause should be amended so as not to apply to temporary support orders defined under Section 71(b)(2)(C). Other provisions of Section 71 do not apply to support orders, in particular the recomputation rules which are excepted under Section 71(f)(5)(B).

II. Section 71(f)(1): Termination on contingencies.

Under Section 71(f)(1) for payments to be alimony, payments in excess of $10,000 must be made under an obligation to pay in each of the six "post-separation" years. The six post-separation years are the six calendar years beginning with the first alimony payment subject to the recomputation rules. The statute provides that any possible termination contingent on the death of either spouse or the remarriage of the payee is not to be taken into account. This provision could be interpreted to disqualify any payment which might terminate for any other reason during that period. For example, alimony payments imposed by a court are always subject to termination on a change in circumstances. This contingency imposed by state law could prevent any alimony deductions for court-ordered payments.

The Temporary Regulations provide that a contingency other than the passage of time is ignored until that contingency occurs. Temp. Reg. Section 1.71-1T, Q/A 23. The regulations take the reasonable position that Congress did not intend to disqualify all court-ordered support payments.

I recommend that Section 71(f)(1) be amended to rephrase its intent by incorporating the standard in the regulations. Payments should qualify as alimony under the six-year minimum term rule unless there is a shorter time period stated in the instrument. Any contingencies should be ignored until the contingency occurs. The other possible amendment would be simply to eliminate Section 71(f)(1). The regulations correctly state that the six-year minimum term rule can be met by payment of as little as $1 in any year. The avowed purpose of preventing excess front-loading of alimony in early years is served by the recomputation rules in Section 71(f)(2). The minimum term rule serves no purpose and is an unnecessary complication.

IV. Section 71(f)(5)(C): Time period for fluctuating payments.

One of the exceptions to the recomputation rules in Section 71(f) is the exception for fluctuating payments as provided in Section 71(f)(5)(C). The recomputation rules do not apply to alimony payments to the extent the payments are made under a continuing liability to pay a fixed portion of the income from a business or property, or from compensation for employment or self-employment. The recomputation rules apply over the period of the six "post-separation" years. These years are the six calendar years beginning with the first alimony payment. If the first alimony payment were made in December of a year, that year would be the first post-separation year.

The fluctuating payments exception to the recomputation rules has a different time period which is stated as not less than six years. This six-year period has been interpreted to mean 72 calendar months, which would usually be a different period from the six post-separation years. Section 71(f)(5)(C) should be amended to require that payments be made over a period which does not end before the end of the sixth post-separation year, rather than require that paymetns under the exception extend for a longer period than payments tested under the recomputation rule.

V. Section 2516: Definition of Husband and Wife.

Under Section 2516, certain property transfers between former spouses are not subject to gift taxes when made under a written agreement. The Tax Reform Act extended the period during which the agreement could be executed to include the period one year after the parties are divorced. Section 2516 refers to the parties who may execute the agreement as "husband" and "wife". Because the agreement could be executed after the divorce, the parties would not be husband and wife at that time.

Section 7701(a)(17) defines "husband" and "wife" to include a former husband and former wife for purposes of certain sections. Section 7701(a)(17) should be amended to add Section 2516 to the sections to which it applies.

VI. Section 6013(e): Innocent Spouse.

The Tax Reform Act expanded the innocent spouse provisions of Section 6013(e). That section applies when a spouse has signed a joint return for a certain taxable year but it would be inequitable to hold that spouse responsible for additional taxes owed for that year because of the actions of the other spouse.

When the erroneous item relates to a claim of a deduction, credit or basis, the innocent spouse must show that the claim had "no basis in fact or law." This is a very high standard of proof. There is no similar standard in any other Code provision. The innocent spouse must prove a negative that there is no basis and the spouse bears the burden of proof.

A more appropriate standard would be the standard used for the imposition of the negligence penalty under Section 6653(a). The spouse could establish innocent spouse status when the claim for a deduction, credit, or basis results from intentional disregard of rules and regulations or is due to the negligence of the other spouse. The spouse could not meet the burden when the claim was made in good faith or on reasonable grounds. The law developed under the negligence penalty would give these spouses and the Service guidance in this area.

When a claim of a deduction, credit, or basis is involved, Section 6013(e) also imposes a percentage test to determine whether the spouse qualifies for innocent spouse treatment. If the innocent spouse's AGI in the year before the deficiency was issued was $20,000 or less, a deficiency must be more than 10 percent of the AGI on that year's return. If the spouse's AGI was more than $20,000, the deficiency must be more than 25 percent of that AGI. The AGI includes all of the income on a joint return.

These tests bear no reasonable relation to the purposes of the statute because the years for measuring the AGI are not related to the year for which the erroneous joint return was filed. For example, assume the innocent spouse filed an erroneous joint return in 1982. If the deficiency is assessed in 1985, the measuring year for the percentage test is 1984. There is no reason to use 1984 as a measurement of whether the spouse was "innocent" in filing the erroneous 1982 return.

These tests are arbitrary in operation. Whether a deficiency is assessed in December of one year or January of the next year can make the difference between "innocence" and "guilt". If a spouse has $1 of income over $20,000, a much stricter test applies to establish innocence. Last, if after the erroneous return was filed, the innocent spouse divorces and remarries, the new spouse's income counts with the innocent spouse's income, even though the parties file separate returns and even though they were not related in the year the erroneous return was filed.

I recommend that Section 6013(e)(4) be eliminated. A more reasonable thresehold test for all cases is the $500 understatement amount in Section 6013(e)(3). As an alternative if the percentage test were retained, Section 6013(e)(4) should be amended to make the year in which the erroneous return was filed the relevant year for applying the percentage test.

VII. Conclusion.

I want to thank the Committee for the opportuntiv to testifv today. I would be glad to answer any questions about my testimony.

STATEMENT OF WILLIAM W. CHIP, COUNSEL TO THE EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION, WASHINGTON, DC

Mr. Chip. Good morning, Mr. Chairman. The first thing I would like to say is that we support the testimony of the National Rural Electric Cooperative Association. There is absolutely no reason at all why these small cooperatives which help farmers on a nonprofit basis should not enjoy the same benefit plans that Fortune 500 companies and others do.

I am here to testify on two technical matters that arose through DEFRA. The first relates to cafeteria plans. Back in 1983, the Treasury became concerned that cafeteria plans would be used by people to expand the amount of their nontaxable compensation by taking free parking and other items that were thought to be tax free and putting them in an elective program. We had no objection to solving that problem, and the technical resolution was to limit cafeteria plans—the nontaxable benefits in cafeteria plans—to your basic social welfare benefits like medical, life insurance, day care, and group legal. The way it was technically resolved was to limit cafeteria plan benefits to "cash" and "statutory nontaxable benefits." Well, we immediately came in and testified that there are a lot of benefits in cafeteria plans that are taxable—vacation pay and any number of other employee benefits that are completely noncontroversial and, because they are taxable, cause no revenue loss. The way that was handled was to place some language in the committee report saying that things like vacation pay, dependent life insurance, and so forth—you could have those in cafeteria plans, and they would be treated as "statutory nontaxable benefits." At the time, we were concerned that people were going to get confused if the Code referred to taxable benefits as nontaxable benefits. The Treasury has apparently come around to the same conclusion and in the Technical Corrections Act is proposing that the term "statutory nontaxable benefits" should be replaced by a new term: "qualified benefits" and that IRS be given the power by regulations to decide what those "qualified benefits" will be. Well, I think waiting for IRS regulations in this area is like waiting for Godot, and Congress ought to resolve this issue itself. I don't think there is any possible objection to putting a benefit in a plan if an employee is willing to pay taxes on the benefit. The definition of qualified benefits should therefore include the basic nontaxable social welfare benefits plus any benefit on which an employee is willing to pay taxes.

The other item I wish to discuss is dependent life insurance. Traditionally, dependent life insurance has not been taxed. However, the only basis for that is a 1957 IRS regulation which says. That an "incidental amount" of dependent life insurance would not be taxed. There is nothing in the Code that says that, which leaves open the question of whether when Congress amended Section 61 under DEFRA you intended to change that. I don't have any reason to believe you did intend to change it, and if you didn't, I suggest that a technical correction be made to clarify that. Thank you.

The CHAIRMAN. You would be amazed at how many times there is simply no idea what our intent was at all. Nobody ever thought about it, one way or the other, and indeed a change is effected, and we honestly don't know what we intended to do. I don't know what our intent might have been, had somebody asked us at the time what our intent was.

Mr. CHIP. In this case it is not even clear what you did, let alone what your intent was. I think that there are many millions of people who receive this benefit and who need to know whether you intend to tax them on it or not.

The CHAIRMAN. Thank you. Mr. Ray?

[The prepared written statement of Mr. Chip follows:]

ecfc **Employers Council on Flexible Compensation**
Suite 600 • 1700 Pennsylvania Avenue, N.W. • Washington, D.C. 20006 • Telephone (202) 393-1728

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STATEMENT BY WILLIAM W. CHIP

ON BEHALF OF THE EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION

BEFORE THE SENATE FINANCE COMMITTEE

ON JUNE 5, 1985

CONCERNING THE TECHNICAL CORRECTIONS ACT

The Employers Council on Flexible Compensation ("ECFC") is the national association of employers that sponsor cafeteria plans and 401(k) plans for their employees. Companies that design or administer these plans may join ECFC as Associate Members.

Cafeteria plans, often called flexible benefit plans, are employee benefit plans in which participating employees may select their medical, life insurance, and other benefits from a menu of benefits offered by the employer. Employees who choose the less expensive benefits may receive additional cash compensation from their employer. Studies by ECFC and by other organizations indicate that cafeteria plans result in somewhat lower utilization by employees of traditional benefits, such as medical insurance, and greater utilization of newer benefits, such as dependent care assistance and group legal services.

Cafeteria Plans

During 1984, the Treasury Department related to this committee its concern that cafeteria plans would be used to deliver free parking and other goods and services to employees without payment of tax. Their proposed solution was to limit the benefits that could be offered in a cafeteria plan to a select group of broad-based welfare benefits referred to as "statutory nontaxable benefits" including medical and disability insurance, group term life insurance, dependent care assistance, group legal services, and 401(k) plans.

During Congressional hearings, ECFC and others pointed out that many standard, noncontroversial benefits provided by employers to their employees are taxable. Since taxable benefits would not qualify as "statutory nontaxable benefits", many benefits would have needlessly been excluded from cafeteria plans. In response, the Tax Reform Act was amended to provide that group term life insurance which was taxable because it exceeded $50,000 would qualify as a "statutory nontaxable benefit". In addition, the Committee reports mentioned vacation pay and group term life insurance that was taxable because it was on the life of a spouse or a dependent as taxable benefits that would be treated as "statutory nontaxable benefits".

The attempt in the Tax Reform Act to account for taxable benefits in cafeteria plans was deficient on two grounds. First, referring to taxable benefits as "statutory nontaxable benefits" may confuse taxpayers. Second, there are a growing number of taxable benefits provided by employers to employees beyond those listed in the Committee Reports, including financial planning services and group automobile insurance.

Section 153(b)(1) of the Technical Corrections Act attempts to correct the deficiencies of the Tax Reform Act by changing the term "statutory nontaxable benefits" to "qualified benefits". This corrects the first deficiency of the Tax Reform Act by eliminating any implication that otherwise taxable benefits such as vacation pay are nontaxable when offered under a cafeteria plan.

To correct the second deficiency of the Tax Reform Act, the Technical Corrections Act empowers the Internal Revenue Service to define by regulation additional taxable benefits that will be treated as "qualified benefits". ECFC believes that this solution does not adequately correct the problem. It took six years and a policy crisis to get the IRS to propose its first cafeteria plan regulations. Seven years after enactment of section 125, the IRS has failed to issue a single favorable cafeteria plan ruling. To leave determination of which taxable benefits are includable in cafeteria plan to the IRS regulations process does not correct the problem. It simply defers the problem far into the future.

The Treasury's original concern, that free parking and other benefits of dubious tax status would become more widely available through cafeteria plans, has in fact been addressed by other provisions of the Tax Reform Act. First, the Act's amendment of section 61 clarified that all fringe benefits are taxable unless the Internal Revenue Code explicitly exempts them from tax. Second, new section 132 clarifies the circumstances under which free parking and other benefits whose tax status was dubious in the past would be tax-exempt in the future. Third, section 125 was amended to make clear that none of the benefits described in section 132, such as free parking, could be included in a cafeteria plan. These changes make completely clear that any benefit offered through a cafeteria plan will be taxable to the recipient if it is not a health or disability benefits, life insurance, dependent care assistance, or group legal services. The appropriate technical correction would therefore be to include in the definition of "qualified benefit" any "benefit that is includable in gross income".

Dependent Medical Insurance

Treasury regulations under section 61 of the Internal Revenue Code have since 1957 stated that an "incidental" amount of insurance on the life of a spouse or dependent of an employee is not includable in gross income. These same regulations further provided that insurance not in excess of $2,000 would be treated as "incidental". Because of inflation, many employers have taken the position in recent years that $5,000 to $10,000 of dependent life insurance is "incidental" and therefore not includable in gross income. Because the cost of this benefit is very low, the revenue implications of its tax status are minor. However, employers need to know whether income tax should be withheld.

The Tax Reform Act of 1984 amended section 61 to clarify that "fringe benefits" would be treated as compensation for purposes of section 61 and therefore includable in gross income. The Committee Reports do not explain whether this amendment was intended to override the 1957 regulations regarding dependent life insurance. Arguably, "incidental" amounts of dependent life insurance may continue to be excludable from taxable income, even if the amendment of section 61 overrides the 1957 regulations, because this benefit may now qualify as a "de minimus fringe" under new section 132(a)(4). Unfortunately, the Committee Reports do not state whether dependent life insurance is a "de minimus fringe".

Clarification of the tax status of dependent life insurance is needed as soon as possible, since this benefit is provided by hundreds of thousands of employers to millions of employees. If the result of clarification is that an "incidental" amount of dependent life insurance is tax-exempt as a "de minimus fringe", a further technical correction to section 125 is required. Benefits that are tax-exempt under section 132 may not be included in a cafeteria plan. The great majority of cafeteria plans do include dependent life insurance and there would appear to be no policy advanced by prohibiting this practice.

STATEMENT OF CECIL A. RAY, JR., HUGHES & LUCE, DALLAS, TX

Mr. **Ray**. My name is Cecil Ray from Dallas, TX. My written statement deals with two proposed changes to the Technical Correction Act of 1985, a proposed addition to it, and two proposed new changes to the Retirement Equity Act.

I want to devote my oral testimony, however, to a proposed amendment to change the effective date on the repeal of the estate tax exclusion for qualified employee benefit plans. In 1984, DEFRA repealed the estate tax exclusion for qualified benefit plans. In 1982, the exclusion had previously been limited to $100,000. The $100,000 exclusion, however, was preserved for some taxpayers, and the total exclusion was preserved for others. To qualify for the exclusion now, for a death that occurs after 1984, two conditions must be met. The first one is that the form of the benefit payment must have been irrevocably elected before 1983 for total estate tax exclusion and before the effective date of DEFRA for the $100,000 exclusion to apply. The second one is the one that I am concerned about, namely, that the decedent must be in pay status before 1983 in order to receive the total exclusion and by December 31, 1984 to receive the $100,000 exclusion.

The meaning of the phrase "in pay status" is not totally clear. The Congressional purpose and the intent of Congress was not expressed in the legislative history. I presume, of course, that Congress did not wish to unfairly burden retirees who had irrevocably elected the form of their retirement income benefits in reliance on the tax laws that existed at the time in question. But the phrase "in pay status" may very well be interpreted to require that the payment of benefits has actually begun before the specified dates. If so, then, those retirees who irrevocably elected to defer their starting date, rather than to receive an immediate payment of benefits, would have the unpaid plan values taxed in their estate. This would be the case for an early retiree—one who retired at 55, but elected to defer his starting date until age 65, hoping to accumulate some additional values to protect him against the uncertainties of old age. He would pay estate tax, but an early retiree who had begun receiving immediate payments would not be taxed.

It seems to me that such a difference in tax treatments for these two classes of taxpayers is unfair and that the estate tax treatment should not be based on whether pension payments have begun or not. Taxpayers who are faced by this change are in the later years of their life. They have no time to compensate or make changes when the estate tax rules on which they relied in planning their estates have been changed. And so, my suggestion is that you remove the pay status concept and replace it with a concept that, if the employee had retired or otherwise terminated employment and made an irreversible election, he would be protected.

My statement also discusses a technical correction in Section 152(e) which affects all community property residents. It would repeal the estate tax exclusion when the nonemployee spouse predeceases the employer spouse. I think this is a policy matter. It was dealt with and rejected by the Conference Committee last year, and I think it should be deleted from the Technical Corrections Act. Thank you, sir.

The CHAIRMAN. Thank you. Mr. Milroy?

[The prepared written statement of Mr. Ray follows:]

STATEMENT OF CECIL A. RAY, JR.

HUGHES & LUCE
1000 Dallas Building
Dallas, Texas 75201

Committee on Finance
United States Senate
June 5, 1985

I. OVERVIEW

Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), benefits under qualified employee plans were essentially excluded from the federal estate and gift tax system. Section 2039(c) of the Code excluded the value of qualified plan benefits from the gross estate of deceased employees. Moreover, neither the selection by an employee of the form of benefits to be paid to him, nor the designation of a beneficiary to receive payments after his death, was a transfer for gift tax purposes. I.R.C. § 2517.

Qualified plan benefits were also protected from adverse federal transfer tax consequences that could have resulted under community property laws. Plan benefits are generally community property owned equally by the employee and a non-employee spouse. Most plans, however, are written as if the employee was entitled to receive and control all benefits. No benefits are payable as a result of the death of a non-employee spouse, nor does the spouse generally have any effective ability to designate a beneficiary for her interest in the plan. The federal estate and gift tax system reflected these realities in two ways. First, section 2039(d) provided that plan values attributable to community property laws would not be included in the estate of a non-employee spouse who predeceased the employee. Second, under section 2517(c), the non-employee spouse would not be considered to have made a taxable transfer when benefits under the plan were transferred.

TEFRA capped the value of qualified plan benefits excludable from the gross estate of the employee at $100,000. TEFRA § 245(a). Section 525(a) of the Deficit Reduction Act of 1984 eliminated the employee's estate tax exclusion entirely, repealing section 2039(c) of the Code for decedents dying after 1984. The repeal did not apply, however, to a decedent who irrevocably elected the form of benefit before July 18, 1984, and who was "in pay status" on December 31, 1984. Deficit Reduction Act § 525(b)(2). Furthermore, the $100,000 cap enacted in TEFRA was made inapplicable to participants who had irrevocably elected the form of benefit before 1983 and were "in pay status" on December 31, 1982. Deficit Reduction Act § 525(b)(3). This provision had the effect of restoring the full pre-TEFRA estate tax exclusion to certain plan participants. I propose that section 525(b) of the Deficit Reduction Act be technically corrected to clearly extend the effective date relief to all participants who had irrevocably elected the form of benefit and had severed employment, regardless of whether under the specific form of benefit elected payments had already commenced.

Section 152(e) of the proposed Technical Corrections Act of 1985, S. 814, repeals the exclusion of the community property interest in plan benefits from the estate of the non-working spouse and repeals the gift tax exclusion for transfers of plan benefits. For the reasons given below, this proposal should be deleted from the technical corrections bill. The final section of this statement suggests technical corrections to the Retirement

Equity Act of 1984 ("REA") dealing with the interests of non-employee spouses.

II. PROPOSED AMENDMENT TO EFFECTIVE DATE RULES

The effective date exception in section 525(b) of the Deficit Reduction Act applies to plan participants who (1) had irrevocably elected the form of their benefits, and (2) were "in pay status." The meaning of the phrase "in pay status" is not transparent, nor is that phrase used generally in the Code. The Committee Reports do not provide any explanation of the Congressional intent underlying the effective date exception. The logical presumption is that Congress did not wish to be unfair to retirees who had elected a form of benefit in reliance on the estate tax exclusion and who could not now change that election. Unfortunately, the words of the statute imperfectly reflect this intention. The requirement that a participant be "in pay status" may be read to mean that actual payments must have begun, thus excluding retirees who had irrevocably elected a form of benefit under which payments do not begin until a more advanced age.

A technical correction to section 525(b) is warranted. The correction should extend the effective date exception to participants who before the applicable dates had (1) irrevocably elected the form of their benefits, and (2) terminated employment. This simple change would prevent clearly inequitable treatment of an unknown number of unsuspecting retirees. Suppose Mr. A and Mr. B both turned 65 and retired in 1981. Mr. A irrevocably elected to receive monthly payments from the company pension or profit-sharing plan commencing immediately. Mr. B believed he had sufficient assets to make ends meet for a few years and was particularly concerned about having sufficient income to meet the expenses of an extended old age. Mr. B therefore irrevocably elected to allow plan values to continue to build and not to begin receiving benefits until age 70-1/2. (The irrevocable election was required to avoid constructive receipt under section 402(a)(1) before its amendment in 1981.) Mr. B realized that this choice would increase the expected value of plan benefits at his death, but he relied on section 2039(c) to exclude those increased benefits from the estate tax. The legislative process, however, has now played a cruel joke on Mr. B. Mr. A, who elected to receive benefits currently, minimizing the plan value in his potential estate, is clearly entitled to exclude any remaining plan benefits from his taxable estate under the effective date exception. Many would say, however, that Mr. B is not entitled to the exclusion because he elected deferred benefits and therefore was not "in pay status" on December 31, 1982. The unfairness is obvious: Mr. A who did not rely on the estate tax exclusion and probably will not have much use for it is entitled to it, while Mr. B who relied on the exclusion and made an irrevocable election that increased his potential estate now has the exclusion withdrawn. The bitter pill may be even harder to swallow because, depending on the exact form of the irrevocable beneficiary designation, the benefits may not qualify for the marital deduction even if Mrs. B survives Mr. B. For example, if Mr. B had irrevocably elected fixed monthly payments for the joint lifetime of he and his spouse, followed by benefits to their children, the benefits passing to Mrs. B would be a terminable interest not qualifying for the marital deduction. See I.R.C. 2056(b). Moreover, if Mr. B dies now, no plan benefits will be available to help pay the estate tax due to the election to defer benefits. One could hardly blame Mr. B and an unknown number of similarly situated retirees if they feel that excluding them from the effective date exception provided to Mr. A stands fairness on its head

III. PROPOSED REPEAL OF SECTIONS 2039(c) AND 2517

The non-employee spouse's community property interest in an employee plan can result in unfair estate and gift tax results for residents of community property states. Although one-half the plan values would be considered property of the non-employee spouse, there is no acceleration of benefits following that spouse's death. If an estate tax was imposed at that time on plan values, those values would not be available to help pay that tax. In Texas, plan assets are not part of the probate estate and, as a result, the non-employee spouse has no ability to direct the disposition of the community share of those assets at death.

Section 2039(c) (formerly 2039(d)) of the Code prevents inequitable treatment of residents of community property states by excluding the community interest from the gross estate of the non-employee spouse who predeceases the plan participant. TEFRA eliminated the general section 2039(c) estate tax exclusion for plan benefits in excess of $100,000, but pointedly did not limit the exclusion for the community property interest under section 2039(d). See I.R.C. § 2039(g) (prior to repeal by the Deficit Reduction Act). Undoubtedly, Congress recognized that even if plan benefits were to be taxed in the estate of the employee, it would still be unfair to tax benefits at the time when the non-employee spouse predeceased the employee. As originally passed by the Senate, the Deficit Reduction Act repealed the community property rule of former subsection 2039(d) along with the general estate tax exclusion of former subsection (c). See H.R. 4170 § 90(a) (as passed by the Senate). The Committee of Conference, however, intentionally reinstated the exception for the community property interest of the non-employee spouse. Thus, two Congresses have previously determined that the non-employee spouse exemption should be retained even where the general exclusion for qualified plan benefits has been eliminated.

Now, a third attempt is made to tax qualified plan benefits on the earlier death of the non-employee spouse. S. 814 § 152(e). This time a policy proposal masquerades as a technical correction. What lays behind the mask, however, is neither technical nor a correction. Instead, it is an attempt to change a sensible and equitable provision that has been endorsed by the last two

Congresses. This legislative "trojan horse" needs to be turned back again.

A proposal is also included in S. 814 that would repeal section 2517 of the Code, which provides that the participant's selection of a form of benefits and designation of a beneficiary do not result in gift tax. Congress should carefully consider whether this sweeping change makes sense. The result is likely to be many inadvertent taxable gifts that will go unreported by unsuspecting donors. In general, a participant now includes the value of plan benefits in his estate even if he designates a beneficiary irrevocably during his lifetime. See I.R.C. § 2039(a). It is difficult to identify a tax policy that requires this tax be accelerated by the repeal of section 2517.

If the general exclusion provided by section 2517 of the Code is to be repealed, the special rule in subsection (c) governing community property interests should be retained. Imposing a gift tax on the non-employee spouse when benefits under a qualified plan are transferred would create unfair and even bizarre results. For example, suppose a plan participant chooses to receive an annuity for his life followed by an annuity in trust for his surviving non-employee spouse with a remainder to his children. If, upon the participant's death, the non-employee spouse does not insist that half the benefits be removed from the trust, she has made a transfer and, without a provision such as section 2517(c) of the Code, she would be subject to a gift tax at that time.

It should be noted that the staff of the Joint Committee on Taxation apparently recognizes that the proposals to repeal sections 2039(c) and 2517 would accelerate the inclusion of plan benefits in the estates of residents of the community property states. The staff asserts, however, that to ameliorate the problem the bill would "clarify" that a marital deduction would be available. Joint Committee on Taxation, Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814), JCS-7-85 at 96 (1985). Unfortunately, no clarification is found in the bill. In fact, substantial statutory revisions to sections 2056 and 2523 would be required to provide a marital deduction everywhere it would be needed.

IV. PROPOSED TECHNICAL CORRECTIONS TO RETIREMENT EQUITY ACT

The provisions of § 417 of the Code added by the REA require the non-employee spouse to consent if a participant elects to waive the otherwise required joint and survivor annuity at the participants retirement or the pre-retirement death benefit should the participant die before retirement. I.R.C. § 417(a)(2). The principles of section 2517 of the Code lead to the conclusion that electing to take less than what is otherwise provided by a qualified plan is a gift. Thus, this consent will be a gift and taxable as such unless the Code is amended to provide otherwise. The gift may not be complete at the time of waiver, but when complete it will be taxable to the consenting spouse unless it somehow qualifies for the marital deduction. It is not clear how this is accomplished since the "gift" may benefit persons other than the spouse (e.g., children). A correct federal estate tax return cannot be filed for the non-employee spouse unless the lifetime taxable gifts are correctly reported. Section 2517 of the Code should be expanded to exclude this consent from taxable transfers.

Finally, it should be made clear whether a non-employee spouse's community property rights in the employee's qualified plan are coterminous with the 50% annuity under section 417. Otherwise, the non-employee spouse in a community property state may be entitled to more than 50% of the plan values accrued on account of the employee's service.

STATEMENT OF DONALD W. MILROY, SENIOR VICE PRESIDENT, OPERATIONS, SKY CHEFS, ARLINGTON, TX

Mr. MILROY. Thank you, Mr. Chairman. I am appearing here this morning with Gene Overbeck, Senior Vice President of American Airlines, on behalf of Flagship, Incorporated, an affiliate of American which conducts business under the name of Sky Chefs. Both Sky Chefs and American Airlines are subsidiaries of the AMR Corporation. Sky Chefs has been the food service arm of American Airlines since 1942, when it was established to provide in-flight catering to passengers on American Airlines flights. For over 40 years, Sky Chefs employees have performed the same functions as their counterparts at United, Northwest, TransWorld, Pan Am, and all the other airlines that over the years have had employees working in flight kitchens or food service commissaries. Employees of Sky Chefs and American are freely transferred between the two companies. For over 40 years, the employees of Sky Chefs have received the same free and reduced rate travel benefits that both American Airlines provided to its employees and that the other airlines provided to Sky Chefs' counterparts within their companies. There was no distinction in this regard between an American employee and a Sky Chefs employee. The fact that Sky Chefs was separately incorporated was not deemed significant. Throughout the last 40 years, Sky Chefs Employees have worked toward their retirement with the comfort that those well-earned benefits would continue. However, the enactment of the Tax Reform Act last year changed all that. It placed the status of Sky Chefs' employees and retirees under a cloud. In the absence of clarification of Section 132, it is the opinion of AMR's tax advisors that tax-exempt travel on American cannot safely be continued for Sky Chefs' employees or retirees without withholding tax on the value of these benefits. Accordingly, American and Sky Chefs have vigorously pursued correction of this inequity. We do not believe that the Senate intended this adverse consequence inasmuch as the legislation specifically addressed and approved the preservation of other similar long-standing benefits. I requested permission to appear here in order to explain the need for a clarification with respect to the line of business restriction in Section 132. I am not asking that you support a proposal which would change the intent of the legislation, nor one which would have any significant impact on revenue. I believe that in addressing a specific concern in the line of business limitation, the long-standing benefits for employees and retirees of Sky Chefs simply fell between the cracks. In February of this year, both Sky Chefs and American requested the IRS to rule favorably on the tax-exempt status of Sky Chefs. That request is still pending. Unfortunately, we have been led to believe that there will be no rulings this year in the area of fringe benefits or in the foreseeable future because the IRS believes that legislation and regulatory changes are likely. As a result, Sky Chefs' employees and retirees find themselves in kind of a no man's land. Since we cannot obtain clarification that we need from the IRS, we believe that clarification in the Technical Corrections Act is an appropriate remedy. On behalf of the 8,000 employees and retirees of Sky Chefs, I urge that the committee give favorable consideration to our request. Mr. Chairman, thank you.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Milroy follows:]

DONALD W. MILROY

SENIOR VICE PRESIDENT OPERATIONS

SKY CHEFS

STATEMENT BEFORE THE SENATE COMMITTEE ON FINANCE

June 5, 1985

This statement is submitted on behalf of Flagship International, Inc., an affiliate of American Airlines doing business under the name of Sky Chefs. Both Sky Chefs and American Airlines are subsidiaries of AMR Corporation.

Sky Chefs is the food service arm of American Airlines. It operates flight kitchens and provides food catering services to American and other airlines at various airports throughout the United States. Incidental to its catering operations, Sky Chefs also operates restaurants and gift shops at some of these airports.

Before the Tax Reform Act of 1984 became effective, Sky Chefs employees received tax exempt travel privileges on American Airlines. For over forty years, there was no distinction in this regard between an American employee and a Sky Chefs employee. The fact that Sky Chefs was separately incorporated was not deemed significant. The fact that Sky Chefs performed catering services for other airlines and operated airport restaurants was not deemed significant.

However, the enactment of the Tax Reform Act last year changed all that. It placed the status of Sky Chefs employees under a cloud. In the absence of clarification of Section 132 of the law, AMR's tax advisors have concluded that tax exempt travel on American cannot safely be continued for Sky Chefs employees without withholding tax on the value of these benefits.

I requested permission to appear here in order to explain the need for a clarification with respect to the line of business restriction in Section 132. The clarification is needed in the case of Sky Chefs which is a separately incorporated arm of the overall airline services business. Our proposal would make it clear that in the case of a controlled group of corporations whose primary business was the provision of airline services, if one member of the group was involved in the provision of services for air passengers or for the operation of aircraft, that member would be treated as engaged in the same line of business as the group member offering air transportation to the public. This treatment would only apply, however, in cases where employees of the first member were eligible for no-additional-cost air transportation services as of October 5, 1983.

We believe that a review of the facts justifies the following three conclusions:

First, Sky Chefs' primary business is the provision of services to airline travelers and related support functions for American Airlines.

Second, these services are functions of the air transportation line of business.

Third, the fact that Sky Chefs is an affiliate rather than a division of American Airlines should not be relevant to a determination of the "line of business" question and should not be grounds for discrimination relative to departments or divisions within other airlines, such as United Airlines, Northwest, Trans World and Pan Am, among others, which provide the same services.

In February of this year, a ruling was requested from the Internal Revenue Service on the status of Sky Chefs employees, and that request is still pending. Unfortunately, we have been led to believe that there simply will be no rulings issued in the area of fringe benefits in the foreseeable future because of the IRS view that further legislation and regulatory changes are likely. As a result, Sky Chefs employees find themselves in a kind of no man's land, without the travel benefits they previously enjoyed.

It is for this reason that we seek the assistance of this Committee in the Technical Corrections Bill. We do not believe it was the intention of the Tax Reform Act of 1984 to deprive Sky Chefs employees and retirees of a privilege they have enjoyed for over 40 years. Since we cannot obtain the clarification we need from the Internal Revenue Service, and since the uncertainty that exists is working a manifest hardship on these employees, we believe that clarification in the Technical Corrections Bill is an appropriate remedy.

If the Committee agrees, the simplest way to accomplish that clarification is by way of an amendment to Section 531(f) of the Tax Reform Act of 1984. The text of such an amendment is our Appendix I. The purpose of Section 531(f), as it reads today, is to clarify the determination of lines of business in the case of retail department store affiliates; and the principle that is now embodied in that section could very simply be extended to airline affiliates such as Sky Chefs.

We urge the Committee to give favorable consideration to this request.

Donald W. Milroy

June 5, 1985

APPENDIX I

June 5, 1985

Amendment to Sections 153 of S-814
The Technical Corrections Act of 1985 *

To amend Section 531 of the Tax Reform Act of 1984.

(f) Determination of Line of Business in Case of Affiliated Group Operating Retail Department Stores or Providing Airline Services - 11 -

(1) as of October 5, 1983, the employees of one member of an affiliated group (as defined in Section 1504 of the Internal Revenue Code of 1954 without regard to subsections (b)(2) and (b)(4) thereof) were:

(A) Entitled to employee discounts at the retail department stores operated by another member of such affiliated group, or

(B) Were eligible for no-additional-cost services in the form of air transportation provided by another member of such affiliated group, and

(2) in the case of the member having employees described in paragraph (1)(B), such member is involved in the provision of services for air passengers or for the operation of aircraft, and

(3) the primary business of the affiliated group is the operation of retail department stores or the provision of airline services, as the case may be,

then, for the purpose of applying Section 132 (A)(2) of the Internal Revenue Code of 1954, with respect to discounts provided for such employees at the retail department stores operated by such other member, and for the purpose of applying Sections 132 (a)(1) and 132 (a)(2) of the Internal Revenue Code of 1954 with respect to air transportation provided for such employees by such other member, the employer shall be treated as engaged in the same line of business as such other member.

* Blacklined to show changes to existing Section 531(f).

The CHAIRMAN. I want to ask you a question and then ask Pan Am a question. Give me the corporate structure again.

Mr. MILROY. AMR is the holding company. American Airlines, Incorporated is a subsidiary. Flagship International, Incorporated is another subsidiary, which does business as Sky Chefs.

The CHAIRMAN. All right. Now, Sky Chefs, as I read your testimony last night, serves a multitude of other clients other than American or in addition to American.

Mr. MILROY. In kitchens where we have space or where an airport permits us, we do have other accounts, other airlines.

The CHAIRMAN. And you also run gift shops.

Mr. MILROY. We run airport restaurants and those places where we have bid on the combination of the food and beverage catering, and airport gift shops.

The CHAIRMAN. Now, how much of your Sky Chefs business gross is from American?

Mr. MILROY. Over 75 percent is American Airlines catering, strictly catering.

The CHAIRMAN. And the other 25 percent is everything else?

Mr. MILROY. Is a mixture of other airlines, international airlines, and——

The CHAIRMAN. The restaurants, the gift shops, everything. So, basically, your overwhelming principal business is serving, in essence, your affiliate—I guess you can call it—since you are both subsidiaries of AMR.

Mr. MILROY. Yes, sir.

The CHAIRMAN. All right. Thank you. Now, let me go to World Services. Explain to me the relationship to Pan Am and what other businesses does World Services do in addition to Pan Am?

Mr. BARNES. Mr. Chairman, as of last summer, Pan Am established a holding company also—the Pan Am Corporation. And Pan American World Airways is one company under the holding company concept, and Pan Am World Services is a second company. There are others.

The CHAIRMAN. And what does Pan Am World Services do? In other words, Sky Chefs has got some independent business where they can work it in with servicing American. What about World Services? What other businesses is it involved in besides servicing Pan Am?

Mr. BARNES. The preponderant part of our business in terms of dollar volume is with the United States Government. We operate the Air Force Eastern Test Range in Cape Canaveral and the Arnold Engineering Development Center in Tennessee. We provide services for a number of other services, like the Army and the Navy, the Trident Submarine Base, and other locations.

The CHAIRMAN. So, as opposed to Sky Chefs, the bulk of your income would be other than from Pan Am flight-related activities?

Mr. BARNES. That would be correct.

The CHAIRMAN. All right. Thank you. I have no other questions. Senator Long?

Senator LONG. Let me see if I understand this. Is it correct that Sky Chefs provides services for airlines other than American?

Mr. MILROY. We have 50 other airlines in addition to American, at some city or another.

Senator LONG. And you provide services for those other airlines as well?

Mr. MILROY. Airline catering services. That is correct.

Senator LONG. I think that is a good idea. Airlines ought to find more ways to use their contract services. I wish they would do that to baggage. Do they do that for baggage?

[Laughter.]

Mr. MILROY. Excuse me?

Senator LONG. Does someone do that for getting the bags off the airlines?

Mr. MILROY. No, but I agree with you. They should.

Senator LONG. I will tell you one thing. They do a better job with the meals than they do with the bags.

[Laughter.]

Senator LONG. I am not talking about American.

[Laughter.]

The CHAIRMAN. Is that the end of your questions?

Senator LONG. That is all I have, Mr. Chairman.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. I heard someone say the other day that every layman knows better than anyone else how to build a fire or to run a hotel or to manage an airline, so I guess you get a lot of free advice on it. As I think back to what we were trying to do, it seems to me that we were trying to stop a proliferation of fringe benefits. I don't think, Mr. Chairman, we were trying to cut out those that were already in existence.

The CHAIRMAN. With one exception or maybe two. One was we definitely cut off the parents of airline employees. I mean, we knew what we were doing there.

Senator BENTSEN. You are quite right.

The CHAIRMAN. And while there was some complaint about that, I don't think that here these companies are asking to have that back. They are saying just don't treat us any differently than the fringes that exist for other airline employees.

Senator BENTSEN. I agree. That is a proper correction. And I do think that when put we in line of business that we don't want to get into the situation where we have to define line of business for every business coming along and that grandfathering in the benefits for those that we are receiving is probably the best course to follow in this kind of a situation. I am interested in knowing, Mr. Milroy, and others, if we took that kind of a course of action, do you think that would be the satisfactory course?

Mr. MILROY. That is grandfathering in the employees who had it only?

Senator BENTSEN. The employees? Yes, the employees who had that benefit. I rather question that we meant to cut them out frankly. I know I didn't. That wouldn't be all you are asking for, obviously.

Mr. MILROY. That would be perfectly acceptable, Senator.

Senator BENTSEN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Boren?

Senator BOREN. I am very sympathetic to the problem that Sky Chefs has been having. Let me just clarify it again. Mr. Milroy, if the employee of Sky Chefs were the employee of an airline—Airline X—as opposed to a subsidiary company of the holding company, performing the tasks, then they would be eligible, as I understand it, to employee benefits without taxation.

Mr. **MILROY**. That is correct, sir.

Senator **BOREN**. So, really the only thing preventing them from getting the same treatment is the fact that there are two separate corporations here, albeit they are subsidiaries of the same holding company?

Mr. **MILROY**. That is correct.

Senator **BOREN**. I think clearly it is an injustice, and I have talked to a number of the employees in the Tulsa area who are impacted by this. And I have talked to them about their duties, which are very similar as you have said—identical, really, to those who work directly for airlines. And I think you have made a very good point, and I hope that it is something that the committee can correct.

Mr. **MILROY**. Thank you, Senator.

The **CHAIRMAN**. Any other questions?

Mr. **BARNES**. Mr. Chairman, if I may make one statement with respect to Pan Am World Services?

The **CHAIRMAN**. Yes, sir.

Mr. **BARNES**. The great majority of the employees of our company are and were employees of Pan Am, and essentially all of the services that we provide are airline-related or aerospace-related services. Thank you.

The **CHAIRMAN**. Thank you, sir, very much, and we thank the panel. Now, we will conclude with a panel of Mr. Greenberg, Mr. Heymann, E.E. Edwards, and Dennis Kenny. Go right ahead, Mr. Greenberg.

STATEMENT OF JACK GREENBERG, VICE-PRESIDENT, TAXES, IU INTERNATIONAL, PHILADELPHIA, PA

Mr. **GREENBERG**. Mr. Chairman and committee members, I am here today to strongly object both procedurally and substantively to the provision in the Technical Corrections Act, Section 110(a) of S. 814, that changes the source of income rules for foreign tax credit purposes. This provision is not a technical correction in that it specifically overrides the long-standing Congressional tax policy concerning 80-20 companies as it affects foreign tax credits. It would also subject 80-20 companies to two sets of rules for foreign tax credit purposes, including two de minimus rules for the amount of U.S. source income the company could receive to avoid income resourcing. Obviously, this would place a severe and complex administrative burden on taxpayers. 80-20 companies are domestic corporations which have more than 80 percent of their gross income from foreign sources. As long as less than 20 percent of a company's gross income is from U.S. sources, the company is considered as paying 100 percent foreign source income. Therefore, 80-20 companies are a congressionally mandated de minimus safe harbor to facilitate foreign business transactions without having to formally incorporate in foreign jurisdictions. 80-20 companies are subject to U.S. taxation on their worldwide income. Such companies were not adversely affected by last year's substantive income sourcing changes. In specific reliance on expressed statutory provisions, IU has set up and uses an 80-20 company as an integral part of its foreign operations and has done so for many years. The 80-20 company is essentially directly and indirectly engaged in business outside the United States, including substantial financing transactions. In part, it raises funds for non-U.S. sources and then lends those funds throughout the IU group, which includes U.S. companies on an as-needed basis. Its income is an integral part of the overall financing, cash flow, and financial functions of the whole group. Its business income is for business purposes, not manipulated income for merely source conversion purposes. The income of the 80-20 company is subject to both foreign and U.S. taxation. The 80-20 company efficiently, practically, and legitimately promotes and facilitates financial transactions and functions outside the United States, permitting more ready repatriation to the United States of dividends, interest, and other income from foreign sources. Along with the necessary utilization of foreign tax credits to avoid double taxation of the various incomes. If the provision is enacted, the supposed technical correction discourages repatriation of income to the United States and leaves the double taxation. IU would have to dismantle or completely restructure the 80-20 business operation because of this supposed technical amendment. If Congress wants to reexamine 80-20 companies, it should do so substantively and not as a mere technical correction. If perceived investment abuses need to be corrected, such legislation should be directed to simpler and narrower remedies to the abuse rather than the proposed change for all 80-20 companies, including IU's. I strongly believe that 80-20 companies serve a useful purpose and must be retained. If not retained, appropriate grandfather rules should be part of any legislation. We would be glad, Mr. Chairman, to work with your staff to ensure fair treatment to us while protecting the Treasury from ingenuous investment schemes. Thank you.

The Chairman. Thank you. Mr. Heymann?

[The prepared written statement of Mr. Greenberg follows:]

STATEMENT OF JACK GREENBERG

VICE PRESIDENT TAXES, IU INTERNATIONAL

PHILADELPHIA, PENNSYLVANIA

S. 814

THE TECHNICAL CORRECTIONS ACT OF 1985

COMMITTEE ON FINANCE

June 5, 1985

Under the Tax Reform Act of 1984 (Section 141 of the Act amending Section 904(g) of the Internal Revenue Code (Tax Code)), for foreign tax credit purposes, income payments by United States-owned foreign corporations were subjected to tracing to the income sources of the corporation, and such income payments were then resourced from foreign to United States source in proportion to the portion of the income of the corporation which was considered United States source. The income payments are not subject to resourcing if less than 10% of the corporation's earnings and profits for the taxable year are attributable to sources within the United States. The purpose of this change in the Tax Code was to prescribe artificial conversion of U.S. income to foreign income.

The above-described changes in the Tax Code did not apply to a domestic corporation which had more than 80% of its gross income from foreign sources (Section 861(a)(1)(B) of the Tax Code) and the income payments of which were considered as being 100% foreign source. This type of corporation is generally known as an 80-20 company which must have less than 20% of its total gross income over a 3-year period from United States sources. Under Section 110(a) of the proposed Technical Corrections Act of 1985 (TCA 85), the Tax Code would be amended to additionally subject an 80-20 company to the above-described tracing and resourcing rules for United States-owned foreign corporations, for foreign tax credit purposes.

In a corporate business group, an 80-20 company is a vehicle to permit and facilitate, under and in accordance with the Tax Code, foreign transactions/activities by a domestic corporation, which are the primary business transactions of such corporation. The corporation is thereby not forced to incorporate its business operations in a foreign country to conduct its business. The 80-20 company has been a part of the Tax Code for more than 20 years.

An 80-20 company pays 100% foreign source income for all purposes of the Tax Code, so long as it meets and continues to meet the 80-20 rules, which include a de minimus rule for U.S. source income allowed to be received by the 80-20 company (less than 20% of the corporation's gross income over a 3-year period). If there are perceived abuses of the 80-20 rules by investment plans promoted by the investment community or by artificial transactions, corrective legislation should be directed to simpler and narrower remedies for the abuse rather than the proposed change for all 80-20 companies, notwithstanding their bona fide business purposes. Furthermore, such legislation should not be proposed as being merely a technical correction. This clearly is a substantive, over-broad proposal to change a particular tax law passed by Congress, which has a long history and provides an effective, practical business operation in accordance with the Tax Code.

Where an 80-20 company is an integral, bona fide part of the finance and financial functions of a business group, the 100% foreign source treatment of its income payments should be continued for all purposes of the Tax Code, including foreign tax credit purposes. It conforms and is structured in accordance with the 80-20 provisions and objectives/intentions of the Tax Code as set by Congress, already is subject to and meets a specified U.S. source income de minimus rule, and has been part of the Tax Code for a considerable time without any "evil" being seen previously. There is no covert hiding or conversion of U.S. source income in an 80-20 company which is an integral part of a business group. The de minimus rule for U.S. source income permitted to an 80-20 company is clearly seen, known, and required to be met with respect to a business 80-20 company. Correspondingly, the 100% foreign source treatment of income paid by such an 80-20 company has always been maintained for all purposes of the Tax Code, including foreign tax credit purposes, notwithstanding that an 80-20 company's income could include a de minimus amount of U.S. source income. Why should a business 80-20 company be subject to two sets of rules for foreign tax credit purposes, including the additional complexity and burden of tracing income sources, particularly as the second set of rules appears to be more of the same conceptual requirement which a business 80-20 company must essentially already meet in order to be an 80-20 company? The proposed "technical change" may really be objecting to the less than 20% threshold established by Congress as too high. The threshold is not too high, and any change is certainly not a "technical" amendment.

The de minimus degree of U.S. source income specified by Congress for an 80-20 company should not be a particular point of concern. For example, interest paid on a U.S. bank deposit to a foreigner is treated as foreign source income for all purposes of the Tax Code, notwithstanding that the bank's income may be 100% U.S. source. By comparison, an 80-20 company must have more than 80% foreign source income. It must meet the less than 20% de minimus rule for U.S. source income in order to be an 80-20 company. This is not the same case as where U.S. source income may be connected to foreign source income because such income is not effectively connected with a U.S. business of the foreign corporation, or because it is a part of an investment scheme or because of artificial transactions. A business 80-20 company is a bona fide business corporation engaged in bona fide business transactions, which are essentially foreign.

Within a corporate business group such as IU, an 80-20 company is essentially engaged, directly and through subsidiaries, in business outside of the United States, including substantial financing/financial functions. In connection with financing, the 80-20 company raises its funds from sources outside the United States rather than within the United States. Such funds are lent throughout the IU group of companies, which includes U.S. companies within the group, since such financing is done on an available, fungible group need basis. The income of the 80-20 company is effectively subject, directly and indirectly, to foreign taxation as well as to U.S. taxation. The income which it pays is an integral part of the overall financing, cash flow and financial functions of the IU business group; such income essentially funds debt service or other financial obligations to foreign lenders or obligees. It is business income, for business purposes; not manipulated-income for source conversion purpose. Although the 80-20 company receives income from U.S. affiliates as well as from foreign sources, as long as it meets the de minimus 80-20 rules of the Tax Code and engages in bona fide business operations, the long-recognized 100% foreign source treatment of income paid by an 80-20 company has efficiently, practicably and legitimately promoted and facilitated these financial transactions and functions outside the United States, including as part of such functions repatriation of dividends, interest and other income from foreign sources along with the necessary utilization of foreign tax credits to avoid double taxation of the various incomes from foreign sources.

Accordingly, we do not believe it is necessary to impose on an 80-20 company, a second set of rules, including another _de minimus_ rule, and also adding substantial complexity/duplication and administrative burdens for foreign tax credit purposes. We fail to see or understand what is wrong or unreasonable with this long-standing congressional tax policy of an 80-20 company. The 80-20 company has always been subject to a _de minimus_ rule for U.S. source income, which is not considered abusive to our knowledge, and such company has generally worked well within a business group. The current treatment of a business 80-20 company under the Tax Code should not be changed, particularly where concerned abuses apparently are seen in investment or other income conversion schemes of the investment community or in artificial transactions. Any changes should be directed to the perceived abuse. Changing the treatment of a business 80-20 company for foreign tax purposes will cause significant negative impacts on the foreign income flows to a business group such as IU, including the need to go through formal restructurings and refinancing to minimize such negative impacts, the possibility of greater exposure to double taxation occuring on repatriation of dividends, the reduction in foreign income repatriation, and the substantial increase in administrative costs of having to comply with complex income-tracing concepts in situations where concerned abuses should not practicably exist.

In summary, we believe that Section 110(a) should be eliminated from the TCA 85. It is far too broad and is inappropriate with respect to a business 80-20 company, for the reasons described above. Additionally, it proposes a substantive and burdensome change in the Tax Code. It is not a mere technical correction and should not be so treated. If a change in the Tax Code is to be considered here, it should be as a substantive legislative proposal for example, as in the Treasury Department Report to the President, Tax Reform for Fairness, Simplicity and Economic Growth, Volume 2, page 367). We, of course, disagree with the appropriateness of this proposal.

We are proposing changes for consideration of the staff which we believe will assure fair and continued treatment of business 80-20 companies while protecting the Treasury from investment schemes which are intended to only convert the source of income.

STATEMENT OF ROGER L. HEYMANN, CPA, HEYMANN, LOEB & COHEN, P.C., ROCKVILLE, MD

Mr. HEYMANN. Thank you, Mr. Chairman. My name is Roger Heymann. I am a CPA. I have been in practice for 15 years. I am here to talk about a problem with the targeted jobs credit and how it is affected by the alternative minimum tax. Since the alternative minimum tax has come into inception, there have been a number of changes whether technical or through the regular code changes affecting the targeted jobs credit. Now, I would like to approach the unique aspect of the targeted jobs credits. When a job credit is taken by an employer who has a program hiring people such as veterans who would be subject to the credit or aids for dependent care, it is necessary to subtract the credit from the salary deduction, increasing income. Now, when you are dealing with a Subchapter S corporation, a partnership or an individual that is on a cash basis, what will happen is you will increase their adjusted gross income. Now, when the credit is not taken due to the alternative minimum tax, you will have a taxpayer paying taxes or paying a minimum tax on the credit because of the reduction of the salary on a benefit that he is not receiving due to the cash basis of accounting and taxation. The credit is carried over to the future, as changed in the last Technical Corrections bill. This creates a problem where you may never take the credit at all. My thought on the matter is that when a taxpayer cannot take the credit, the credit not taken in that year should be carried forward and added to the future minimum taxable income and not have generate a minimum tax on the credit that he cannot take in the year that he receives it. I have clients that hire a number of these people, and what has been happening is they have been discouraged due to the credit and the fact that they were Subchapter S corporations, they were found to be paying more taxes by hiring these targeted groups. In some cases, we have reluctantly eliminated the Subchapter S status and cut back on hiring people from these programs. I know it is uncertain as to whether the credit will be renewed at the end of this year, but if it is, I would hope that the alternative minimum tax and its application to the credit can be changed so that where we don't use the credit and it is carried forward, we would not pay a minimum tax on the credit due to the wage add back. There is something else that has been entered into the bill concerning the tax benefit rule, and this is sort of like the tax benefit rule in reverse, where it increases income but does not reduce the tax. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Mr. Edwards?

[The prepared written statement of Mr. Heymann follows:]

TESTIMONY OF
ROGER L. HEYMANN, CPA
BEFORE THE
SENATE COMMITTEE ON FINANCE

Dear Mr. Chairman and Members of This Distinguished Committee:

I am Roger L. Heymann, CPA and I am appearing as an expert witness in regard to the targeted jobs credit and the alternative minimum tax. I am a certified public accountant practicing in Maryland, District of Columbia, and New York. I have been practicing since 1972 and also a member of the American Institute of Certified Public Accountants. I have come to speak to you regarding the targeted jobs credit.

TARGETED JOBS CREDIT

An inequity now exists for individuals, partnerships, and S corporations, in regard to the wage add on provision of the targeted jobs credit. If not remedied, this inequity will discourage the use of the credit for unincorporated businesses and S corporations. The alternative minimum tax of individuals will apply to the credit although the tax benefit of the credit may not be realized for years.

In an attempt to encourage the employment of certain difficult to employ or economically disadvantaged persons, Congress enacted legislation to give business employers the incentive to hire members of certain targeted groups. This is the "targeted jobs credit" covered under various parts of sections 51 and 53 of the Internal Revenue Code. This credit now falls under a general business credit.

The treatment of the credit has changed from time to time. It has either been treated like the foreign tax credit, reducing the alternative minimum tax, or has not been available to offset the alternative minimum tax. Congress has finally decided that credits not attributable to prior tax payments should not be allowed as alternative minimum tax offsets.

The taxpayer will not enjoy the full tax benefit of the targeted jobs credit (a non-refundable credit) which is otherwise allowable for the taxable year against regular tax. Congress has permitted an election 51(J)(1) and under 55(C)(3) permits an additional carryover of a non-refundable tax credit equal to the tax benefit of the credit lost due to the imposition of the alternative minimum tax.

There is a unique problem! The employer's deduction for wages paid must be reduced by the full amount of the targeted jobs credit, without regard to the availability of the full tax benefit. We have converted the unused credit into a tax preference item for individuals of small businesses, partnerships, and S corporations. In a year when the taxpayer has received no cash benefit, a cash basis taxpayer will still be paying 20% tax. Therefore, the credit generated by the training of the targeted group becomes a loss. An add on of $1.00 of wage adjustment, can create a 20 cent alternative minimum tax without the use or benefit of the credit. Not using the credit was not the intent of Congress. The problem is that you may never benefit from the use of the credit.

The targeted jobs credit is unique because it increases the taxable income of individuals without a real increase in cash received. Providing training and generating jobs is also unique. Private employers training and employing the potentially unemployable will save many government dollars. I believe that is the intent of Congress.

The solution to this problem is that Form 6251 be amended and Congress permit the unused credit to be an adjustment either reducing or increasing the A.M.T. taxable income. A line similar to line 2(e) of form 6251 would be a good way to approach this adjustment.

An approach similar to 55 (e) (the net operating loss provision) in order to arrive at the alternative tax targeted job credit to the extent the credit creates a tax preference increase in income.

The unused credit can be an alternative minimum tax itemized deduction. When used in the future, it can be an addition to the Adjusted Gross Income.

In my work with labor intensive organizations, I have observed the direct financial benefit to persons formerly called economically disadvantaged. They are now called taxpayers thanks to Congress and the targeted jobs credit. I am very grateful for you permitting me to share my views.

STATEMENT OF E.E. EDWARDS III, CHAIRPERSON, DEFENSE FUNCTION COMMITTEE, SECTION OF CRIMINAL JUSTICE, AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Mr. EDWARDS. Thank you, Mr. Chairman. My name is E. E. Edwards, or "Beau" Edwards in Nashville. I am a practicing lawyer in Nashville, Tennessee, and I am representing the American Bar Association, and I suppose you could say indirectly I am also representing the point of view of a number of other bar groups around the country—the American Trial Lawyers Association, the National Association of Criminal Defense Lawyers, the New York City Bar, the Dade County Bar, the Illinois State Bar—a number of bar groups that have expressed a deep concern about an unanticipated impact on the attorney-client relationship in this country as a result of the enactment of Section 6050(i) which is the currency reporting requirement extension to people engaged in a trade or business. I think the best way to illustrate the problem is for you to consider a man who believes he may have a legal problem of some sort and walks into a lawyer's office to seek advice and counsel. Now, assume if you will that the person enters the lawyer's office feeling that he has a problem, but so far no one else has become aware of the potential problem. He talks to a lawyer, explains the problem. The lawyers listens and tells the man: Yes, I believe you have a serious legal problem, one that is likely to take considerable time and effort to deal with. And the man says, well, Mr. Lawyer, I would like to retain you to represent me, and I would like to pay you in cash. And they discuss a retainer and it is agreed to. If the retainer is more than $10,000, or if it reaches over a period of time more than $10,000 accumulatively, the first thing the lawyer is going to have to say to his new client is: I will be happy to represent you. I will do everything that I can that is ethical and legal to protect your interests and defend your rights, but first, I want you to give me your name and Social Security number, passport number, and I am going to report you to the Government. Well, obviously, that has an extraordinarily chilling effect upon the exercise of the citizen's right to have legal counsel, a right that in many circumstances is protected by the right to counsel of the Sixth Amendment. Citizens have always been able to go to a lawyer whenever they felt the need and get advice, without the fear that the confidentiality that has always been accorded that relationship will be breached. I suggest that the fiscal impact of exempting attorneys' fees and expenses from 6050(i) would be minimal. But what I think is important to point out is that cash payments to lawyers are going to be reported under the Bank Privacy Act anyway. The lawyer is going to report the money when he deposits it to his law firm account. It is just that he will be reporting his name, his taxpayer identification number, and not his client's, and it is the client that we seek to protect by asking for the exemption of legal fees and expenses.

The CHAIRMAN. Thank you.

Mr. EDWARDS. Thank you very much.

The CHAIRMAN. Thank you. Mr. Kenny?

[The prepared written statement of Mr. Edwards follows:]

AMERICAN BAR ASSOCIATION

GOVERNMENTAL AFFAIRS GROUP • 1800 M STREET, N.W. • WASHINGTON, D.C. 20036 • (202) 331-2200

STATEMENT OF

E. E. EDWARDS, III

CHAIRPERSON,
DEFENSE FUNCTION COMMITTEE
CRIMINAL JUSTICE SECTION

ON BEHALF OF
THE
AMERICAN BAR ASSOCIATION

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

CONCERNING
CASH TRANSACTION REPORTING PROVISIONS OF
26 U.S.C. §6050I

June 5, 1985

Mr. Chairman and Members of the Committee:

My name is E. E. Edwards, III. I am a trial attorney and partner in the law firm of Edwards, Turner and Thompson in Nashville, Tennessee. I appear before you today on behalf of the more than 315,000-member American Bar Association.

Currently, I serve as Chairperson of the ABA Criminal Justice Section's Defense Function Committee. The Criminal Justice Section is one of two Sections within the Association that have been asked by the ABA House of Delegates to implement the position that I will articulate in this statement.

The American Bar Association includes within its organization a diverse array of law practice disciplines. Some of the Sections representative of these disciplines include "Criminal Justice," "Corporation, Banking and Business Law," "Real Property, Probate and Trust," and "Taxation."

All segments of the justice system are also represented in the Association. It includes judges, prosecutors, defense attorneys, academics and others.

In February 1985, the American Bar Association adopted a policy expressing concern about the ramifications of recently enacted 26 U.S.C. §6050I. Other organizations have passed similar resolutions. These include, for example, the American Trial Lawyers Association, the Illinois Bar Association, and the Association of the Bar of the City of New York. Examples of these resolutions are attached as Exhibit "A."

I appear before you to detail the reasons that lead to this policy's passage. I will also explain why it is appropriate for this Committee to amend S. 814, the Technical Corrections Act, to address the concerns that prompted the ABA to adopt this policy. The amendment we suggest as a remedy to the unique dilemma posed for both attorneys and their clients by §6050I would include an exemption from that section's reporting requirements for the attorney-client relationship.

BACKGROUND ON PRESENT LAW

Section 6050I of Title 26 of the United States Code was one of the tax reform measures included in the Deficit Reduction Act of 1984. The statute provides that any person who receives more than $10,000 in cash, including foreign currency, in the course of trade or business must file a return with the Internal Revenue Service stating:

(1) the name, address and tax identification number of the person from whom the cash was received;
(2) the amount of cash received;
(3) the date and nature of the transaction; and
(4) such other information as the Secretary of the Treasury may require.

The reporting requirement applies if the cash is received in one transaction or "two or more related transactions." The temporary regulations and Internal Revenue Service form issued to implement §6050I state that the report must be filed by the 15th day after the date of the transaction.

The statute imposes a second reporting obligation. Every person who filed a currency transaction return of the kind described above must annually furnish to each person whose name is set forth in the return a written statement showing; (1) the name and address of the person submitting the return; and (2) the aggregate amount of cash received by that person. This statement must be furnished to the payor on or before January 31st of the year following the calendar year in which the currency reporting return was filed.

The statute exempts three categories of cash transactions from the reporting requirements: (1) cash received in a transaction reported under Title 31, if the Secretary of the Treasury concludes that this would result in duplicate reporting; (2) cash received by financial institutions, as that term is defined in 31 U.S.C. §5312(a)(2); and (3) except to the extent provided for in regulations, transactions occurring entirely outside the United States.

PENALTY PROVISIONS

Civil penalty provisions of Title 26 are applicable to failing to file or furnish the currency transaction reporting return or the annual statement. Penalties under §6652(a)(1) apply to failure to file the §6050I return.

Section 6652(a)(1) provides that each failure to file a return is subject to a $50 penalty "unless it is shown that such failure is due to reasonable cause and not willful neglect." The total penalty imposed during any calendar year cannot exceed $50,000.

Penalties under §§6652(a)(3)(A) and 6678 (a) are applicable to both the Internal Revenue Service return that must be filed and the annual statement that must be provided to persons who are the subject of the return. Section 6652(a)(3)(A) provides that if the failure to file the return is "due to intentional disregard of the filing requirement," it is subject to a $100 penalty and the $50,000 annual limitation does not apply. Section 6678(a) provides that each failure to submit an annual statement to the payor is subject to a $50 penalty unless the failure is due to reasonable cause and not to willful neglect. Again, the total penalties assessed during any calendar year cannot exceed $50,000.

In addition to the civil penalty provisions, the IRS has announced that a willful failure to file the currency transaction reporting return or to disclose information required by the form may result in a misdemeanor criminal prosecution under 26 U.S.C. §7203. A copy of the IRS press release is attached as Exhibit "B."

LEGISLATIVE HISTORY

The tax reform bill introduced in the House of Representatives during the 98th Congress did not contain a currency transaction reporting requirement. It was first proposed in the "Omnibus Reconciliation Act of 1983" introduced as Senate Bill 2062.

An excerpt from the Senate Budget Committee report discussing the relevant portion of the bill is attached as Exhibit "C." It provides some language important to understanding the legislative intent in passing the reporting requirement.

The report expresses the Committee's concern that "approximately 80 percent of the revenue lost through noncompliance [with the tax laws] is attributable to the underreporting of income." It notes a 1981 IRS estimate that taxpayers filing returns failed to report $134 billion in income and that non-filers failed to report an additional $115 billion. This resulted in total lost tax revenues of $55 billion. Unreported income generated from illegal activities resulted in an additional $9 billion in lost tax revenue. The report then states the Committee's belief that "reporting on the spending of large amounts of cash will enable the Internal Revenue Service to identify taxpayers with large cash incomes."

These passages make it clear that the purpose of the currency reporting requirement, as envisioned by the Senate Budget Committee, was to raise tax revenues by identifying individuals who were not accurately reporting their incomes. It was not viewed primarily as a criminal law enforcement measure.

The report also makes it clear that the reporting requirement applies with respect to any receipt of cash in connection with a trade or business "whether or not the receipt constitutes income in the trade or business." Therefore, if a retainer fee in excess of $10,000 is deposited to an attorney's trust account, it would still have to be reported, even though the fee will be earned over a period of time, as services are rendered. Likewise, any cash sums that are the property of an estate or a client that are deposited with an attorney would also have to be reported.

The Conference Committee appointed to resolve differences between the House and Senate bills decided to include the currency transaction reporting requirement in the final Act. An excerpt from the Conference Committee report is attached as Exhibit "D." It is significant because it does not raise any addition points indicating that monies exchanged in the attorney-client relationship were intended to be embraced by the reporting requirement.

IRS FORM 8300

The Internal Revenue Service has issued Form 8300 for reporting currency transactions. A copy of the form is attached as Exhibit "E." The form is significant in several respects.

As noted previously, the statute requires recipients of cash to file a return identifying the person "from whom the cash was received." The "plain meaning" of this phrase indicates that if a third party physically delivered a cash fee on behalf of the client, the return would only have to identify the third party.

Form 8300 alters and greatly expands the "plain meaning" of this statutory phrase. Part I of the form requires that identifying information be provided about the individual or organization "for whom this transaction was completed." Part II of the form requires the same information for the "individual conducting the transaction...." The form states that Part II is to be completed "only if an agent conducts a transaction for the person in part I." Thus, the form clearly requires disclosure of the actual client's identity even if he does not personally tender the cash fee.

The form requires that the recipient of the cash disclose the following information about the payor and the transaction: (1) full name; (2) address; (3) employee identification number; (4) passport number and country of issuance; (5) alien registration number and country of issuance; (6) amount of cash received; (7) amount of cash received in the form of $100 bills; (8) nature of the transaction by general category (e.g., "business services provided"); (9) description of the property or service involved in the transaction; (10) method of payment (U.S. currency, coin or foreign currency); and (11) the date of payment. The recipient must also disclose his own name, address and social security or employee identification number. The form must be signed under penalty of perjury.

The "General Instructions" accompanying the form contain a statement which provides some insight into IRS' view of the purpose of the currency reporting requirement:

> "The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you are required to provide it to us. The requested information is useful in criminal tax and regulatory investigations. In addition to directing the Federal Government's attention to unusual or questionable transactions, the reporting requirement discourages the use of currency in illegal transactions."

This statement reveals that the IRS views the currency reporting requirement as a tool for investigating and deterring criminal conduct, rather than a mechanism for raising tax revenues.

The instructions also state that the form is to be filed by the 15th day after the date of the transaction, either with the Internal Revenue

Service Data Center in Detroit, Michigan or by hand delivery to any local IRS office.

If the aggregate amount of cash received in two or more installment payments exceeds $10,000, the 15 day period is measured from the date of the payment that causes the aggregate amount to exceed $10,000.

Finally, in defining what constitutes a transaction in cash, the form provides that the reporting requirement applies only to the physical receipt of cash. It states, "A transaction in cash does not include a receipt of funds by means of bank check, bank draft, wire transfer, or other written order that does not include the physical transfer of cash."

TEMPORARY IMPLEMENTING REGULATIONS

On May 23, 1985, the Internal Revenue Service published temporary regulations in the Federal Register to implement §6050I. A copy is attached as Exhibit "F." It was made clear that "...these regulations reguire attorneys to report with respect to the receipt of cash in excess of $10,000...." Nevertheless, tacit recognition of the potential problems that reporting might pose for attorneys was evidenced by the statement, "[T]he [Internal Revenue] Service will entertain comments from the legal community concerning the possibility of developing an exception to the reporting requirement for information on transactions which might fall within the scope of the attorney-client privilege."

The announcement accompanying the regulations stated, "...[t]here is a need for immediate guidance. Therefore, these regulations have been published in question and answer format in order to facilitate their timely publication." In order to provide this guidance, a number of the "answers" included in the regulations contain examples of scenarios to illustrate the point being made. Several of these (e.g. Q-5, A-7, A-9(b)) specifically mention attorneys. Others mention situations often encountered by attorneys, such as those involving trusts, escrow arrangements, real estate transactions and debt collection.

The use of specific references to attorneys and matters that they frequently handle serves to illustrate the anticipated extent to which it can be expected that §6050I will impact on the attorney-client relationship. Nevertheless, as has been indicated previously in this statement, the legislative history gives no indication that Congress considered potential ramifications for that relationship. The remaining portion of this statement provides a cursory review of some of the problems it poses.

PROBLEMS POSED BY THE REPORTING REQUIREMENT

Government within our country, at all levels, has historically recognized that certain relationships should be zealously protected from unwarranted intrusion, public or private. Among these, the attorney-client relationship is universally recognized and honored.

The currency transaction reporting requirement poses a serious threat to the integrity of the attorney-client relationship, particularly in the criminal defense area. The requirement that defense attorneys inform the IRS when a client pays a cash fee in excess of $10,000 will have a destructive effect on the actual ability of clients to retain lawyers. It will also adversely affect the trust and confidence essential to a meaningful attorney-client relationship.

Furthermore, the attorney's submission of the form will generate evidence which could be used against the client in a prosecution for tax evasion, participation in a continuing criminal enterprise, and other federal criminal offenses. It is also likely that defense attorneys who submit the forms will find themselves designated as government witnesses and disqualified from further representation of their clients.

Undercover operations designed to trap lawyers into violations of the reporting requirements are also a very real possibility.

The attorney-client relationship is so central to the position of the citizen vis-a-vis the government in our country that it is guaranteed and protected by the Sixth Amendment. At the core of this relationship guaranteed by the Amendment is the attorney-client privilege. Citizens must have the freedom to obtain and pay for legal consultation privately, without fear that their lawyer will be required to report the formation of the relationship or any details concerning it to anyone, including the government.

The policy behind the attorney-client privilege is to promote "freedom of consultation of legal advisers by clients" absent any apprehension that disclosures concerning the consultation can be compelled. United States vs. Hodge and Zweig, 548 F.2d 1347, 1353 (9th Cir. 1977), citing 8 J.Wigmore, Evidence, §2291 at 545 (McNaughton Rev.Ed 1961). Accord In Re Grand Jury Investigation, 723 F.2d 447, 451 (6th Cir. 1983). As a practical matter, if a citizen knows that information could "more readily be obtained from the attorney following disclosure than from himself in the absence of disclosure," the citizen will naturally become reluctant to seek out legal advice and to confide in his lawyer. Fisher v. United States, 425 U.S. 391, 403 (1976). It is virtually assured that §6050I's application will insidiously undermine the basic trust and reliance which citizens must have when they seek legal counsel.

In many instances §6050I will also directly violate the attorney-client privilege. It is frequently stated that "absent unusual circumstances the identity of the client does not come within the attorney-client privilege," Gannett v. First National State Bank of New Jersey, 546 F.2d 1072, 1073 n.4 (3rd Cir. 1976), cert. denied, 431 U.S.

954 (1977); In Re Grand Jury Procedures (Pavlick), 680 F.2d 1026 (5th Cir. 1982)(en banc), and that the legal fee paid by the client is also not within the privilege. See In Re Michaelson, 511 F.2d 882, 888 (9th Cir.), cert. denied, 421 U.S. 978 (1975); In Re Grand Jury Proceedings, 517 F.2d 666, 670 (5th Cir. 1975). So many circumstances have been identified as exceptions, however, the exceptions have become as prevalent as the general rule.

Courts have decided the applicability of the privilege based upon a case by case analysis. Never has there been any willingness to permit wholesale disclosure requirements, some of which would clearly invade constitutionally protected rights and relationships.

The client's identity is protected by the privilege when the client himself would be privileged from such a disclosure. See Fisher, supra 425 U.S. at 404. For example, when a client would have a fifth amendment privilege to refuse to answer questions about cash payments made by him, his attorney could not be compelled to disclose facts about the payment.

Where a strong possibility exists that disclosure of information would implicate the client in the very matter for which legal advice was sought, the privilege applies. In Re Grand Jury Subpoenas Duces Tecum (Marger/Merenbach), 695 F.2d 363, 365 (9th Cir. 1982); In Re Walch, 623 F.2d 489, 495 (7th Cir.), cert. denied, 449 U.S. 994 (1980); In Re Grand Jury Investigation (Tinari), 631 F.2d 17, 19 (3rd Cir. 1980), cert. denied, 449 U.S. 1083 (1981). The client's identity is also privileged where the disclosure would be tantamount to disclosing an otherwise protected confidential communication, Baird v. Koerner, 279 F.2d 623, 632 (9th Cir. 1960), and where so much of the actual communication has already been disclosed that identification of the client amounts to disclosure of a confidential communication. NLRB v. Harvey, 349 F.2d 900, 905 (4th Cir. 1965); United States v. Tratner, 511 F.2d 248, 252

(7th Cir. 1975); Colton v. United States, 306 F.2d 633, 637 (2nd Cir. 1962), cert. denied, 371 U.S. 951 (1963). Another exception is recognized when disclosure of the identity of the client would provide the "last link" of evidence in an existing chain of incriminating evidence likely to lead to the client's indictment. In Re Grand Jury Proceedings (Pavlick), supra; In Re Grand Jury Proceedings (Twist), 689 F.2d 1351, 1352-2 (11th Cir. 1982).

From a broader perspective, every reported case construing the attorney-client privilege arose because the government was focusing, in some manner, attention on some individual who happened to be the attorney's client. The individual had been subpoenaed, or arrested, or indicted, or in some manner had come to the attention of the government.

For the first time in our history, §6050I marks a basic departure from every reported case. For now, a lawyer will be placed in the position of "waiving the flag" at the government and calling the government's attention to a client, in whom, the government may have had no interest. This would be triggered simply by the client's seeking to obtain legal assistance and paying in cash.

Lawyers in many states will have an ethical duty to resist the application of §6050I to their clients under their duty to "preserve the confidences and secrets of a client". Canon 4. This Canon has been widely construed as establishing a duty for lawyers to protect more than only the privileged disclosures of their clients, but extending to any matter which "could be embarrassing or would likely be detrimental to the client." Disciplinary Rule 4-101(a); Standard 28(c); Ethical Consideration 4-1 and 4-5. See State Bar of Georgia, Advisory Opinion Number 41 (September 24, 1984); District of Columbia Bar Association, Committee on Legal Ethics Opinion, Committee on Legal Ethics Opinion Number 124 (March 22, 1983); Philadelphia Bar Association, Professional

Guidance Committee Opinion Number 81-95 (undated); Birmingham Bar Association, Opinion of Professional Ethics (unnumbered) (January 9, 1981); Connecticut Bar Association, Committee on Professional EThics Informal Opinion Number 81-3 (October 9, 1980). Several of these ethical opinions also suggest that an attorney has a duty to utilize all appellate avenues before making any compelled disclosure.

The target of §6050I was obviously the disclosure of large consumer transactions, not transactions relating to privileged relationships which, in economic terms constitute but a drop in the bucket. Because the attention of Congress was focused on other types of transactions, apparently no thought was given to the impact of §6050I on attorney-client relationships.

We urge that, by amending S. 814, transactions which establish or maintain a privileged attorney-client relationship be exempted from the application of §6050I. Such an exemption would avoid a quagmire of litigation, including questions of constitutionality, and would detract little from the overall impact of this section's intended purpose -- revenue collection.

CONCLUSION

In summary, three points are important to reiterate:

1. It seems readily apparent that Congress, in passing §6050I, did not focus on its potential impact on the attorney-client relationship and did not intend to affect that relationship.
2. The purpose of the currency reporting requirement was to raise tax revenues not to create a new criminal law enforcement measure.
3. Section 6050I, however unintended, seriously erodes the confidentiality of attorney-client relationships. It threatens the ethical obligation of attorneys to protect their client's

secrets and confidences. In certain circumstances, it would violate the attorney-client privilege and would be unenforceable as an unconstitutional violation of the Fifth and Sixth Amendments. Furthermore, the revenue to be gained by eroding the attorney-client relationship is minimal.

Therefore, it is wholly appropriate for the Committee on Ways and Means to include a provision in S. 814 exempting the attorney-client relationship from the requirements of §6050I of the Internal Revenue Code. This is a practical application of the technical corrections process to clear up a problem that Congress never intended to create by enacting the law.

Thank you very much for the opportunity to bring this to your attention.

Attachments

1104c

EXHIBIT "A"

American Bar Association

SECRETARY
William H. Neukom
3900 First Interstate Cente
Seattle, WA 98104

WRITER'S DIRECT LINE 312/988-5155

March 18, 1985

Honorable Daniel Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

RE: Deficit Reduction Act

Dear Mr. Chairman:

At the meeting of the House of Delegates of the American Bar Association held February 18-19, 1985, the attached resolution was adopted upon recommendation of the Illinois State Bar Association. The action taken thus becomes the official policy of the Association in this matter.

This resolution is transmitted for your information and whatever action you may deem appropriate. If hearings are scheduled on the subject of this resolution we would appreciate your advising Robert D. Evans, Director of the American Bar Association Governmental Affairs Group, 1800 M Street, N.W., Washington, D.C. 20036, (202/331-2214).

Please do not hesitate to let us know if you need any further information, have any questions or if we can be of any assistance.

Sincerely yours,

WHNeukom

William H. Neukom

WHN:dmb
Attachment
1619f/0268q/0269q

cc: Jon W. DeMoss, Esquire
President, Illinois State Bar Association
Robert D. Evans, Esquire

750 NORTH LAKE SHORE DRIVE, CHICAGO, ILLINOIS 60611
TELEPHONE (312) 988-5000

Resolution Adopted
by the
American Bar Association
House of Delegates

1985 Midyear Meeting
February 18-19, 1985

Report No. 8C

BE IT RESOLVED, That the American Bar Association expresses deepest concern over the effect upon the attorney-client privilege and upon the confidentiality of the attorney-client relationship of Section 6050I of the Internal Revenue Code, added by Section 146 of Title I of the Deficit Reduction Act of 1984, which requires disclosure of certain cash receipts in excess of $10,000;

BE IT FURTHER RESOLVED, That the American Bar Association urges the Department of the Treasury to delay issuance of regulations implementing Section 6050I with respect to receipt by lawyers of cash fees or expenses for legal services until an appropriate solution to this problem can be devised; and

BE IT FURTHER RESOLVED, That the Sections of Taxation and of Criminal Justice be authorized and directed to work with Treasury Department and Internal Revenue Service officials and with appropriate Committees of the Congress in an effort to exempt from disclosure requirements cash fees or expenses received by lawyers for legal services.

1577f/2

THE ASSOCIATION OF TRIAL LAWYERS OF AMERICA
1050 31ST STREET, N.W., WASHINGTON, D.C. 20007-4499 (202) 965-3500

CRIMINAL LAW SECTION

Jack B. Zimmermann
Chairman
Five Post Oak Park
Suite 1130
Houston, TX 77027
(713) 552-0300

Francis J. Hartman
First Vice Chairman
100 High Street
Mount Holly, NJ 08060
(609) 267-5030

John F. Romano
Second Vice Chairman
1601 Belvedere Road
P.O. Box 3466
West Palm Beach, FL 33402
(305) 684-9000

Joseph Lawless, Jr.
Secretary
Fourteenth Floor
Three Penn Center Plaza
Philadelphia, PA 19102
(215) 496-0755

May 1, 1985

Barry Tarlow, Esquire
9119 Sunset Boulevard
Los Angeles, California 90069

Dear Barry,

Enclosed is a copy of the Resolution passed by the Board Of Governors of the Association of Trial Lawyers of America at its meeting in Austin, Texas on April 26, 1985.

Please advise me as soon as possible as to who I should contact, or advise the appropriate person to contact me, so that the Association of Trial Lawyers of America can work in conjunction with the American Bar Association and National Association of Criminal Defense Lawyers on this matter. Our civil lawyers were as concerned about this as were the criminal defense lawyers.

ATLA's 50,000 members should be a positive influence in this fight.

Sincerely,

Jack

Jack B. Zimmermann

JBZ/wb

Enclosure

cc: National Officers & Executive Committee
Officers, Criminal Law Section
Ms. Marianna Smith
Mr. Alan Parker
Mr. Michael Starr
Mr. Sidney Bernstein
Mr. Mark Kadish

BE IT RESOLVED, that the Criminal Law Section of the Association of Trial Lawyers of America expresses deepest concern over the effect upon the attorney-client privilege and upon the confidentiality of the attorney-client relationship of Section 60501 of the Internal Revenue Code, added by Section 146 of Title 1 of the Deficit Reduction Act of 1984, which requires disclosure of certain cash receipts in excess of $10,000;

BE IF FURTHER RESOLVED, that the Association of Trial Lawyers of America urges the Department of the Treasury to delay issuance of regulations implementing Section 60501 with respect to receipt by lawyers of cash fees or expenses for legal services until an appropriate solution to this problem can be devised; and

BE IT FURTHER RESOLVED, that the Board of Governors of the Association of Trial Lawyers of America appoint the Chairman of the Criminal Law Section to head a committee to work with Treasury Department and Internal Revenue Service Officials and with appropriate Committees of the Congress in an effort to exempt from disclosure requirements cash fees or expenses received by lawyers for legal services.

Sidney Bernstein,
Former Chairman
Criminal Law Section

Kluwer Law Book Publishers, Inc.
The Bar Building
36 West 44 Street
New York, NY 10036

Jack B. Zimmermann

Jack B. Zimmermann
Chairman
Criminal Law Section

Law Offices Of Jack B. Zimmermann
Five Post Oak Park
Suite 1130
Houston, Texas 77027

EXHIBIT "B"

News
Release

Department of the Treasury
Internal Revenue Service
Public Affairs Division
Washington, DC 20224

Media Contact: Tel. (202) 566-4024
Copies: Tel. (202) 566-4054

IR-84-132

For Release: 12/20/84

Washington -- The Internal Revenue Service today announced the availability of Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business.

The Tax Reform Act of 1984 provides that any person who in trade or business receives more than $10,000 in cash, including foreign currency, after 1984 in one transaction or related transactions must file a return of this information to the IRS.

Banks and other financial institutions required under the Bank Secrecy Act to report cash transactions of more than $10,000 to the Treasury are not required to file Form 8300. Also, reporting is not required for transactions entirely outside the United States.

Form 8300 contains provisions for the payer's name, address and tax identification number, the amount received and the date and nature of the transaction. The law requires that a written statement must also be provided to the payer. A copy of Form 8300 may be used as the statement.

A person who fails to file required Forms 8300 with the IRS or to furnish the payer with the required statement is subject to a $50 penalty per failure, up to a $50,000 maximum penalty per calendar year. No penalty will be imposed if the failure is shown to be due to reasonable cause and not to willful neglect. If the failure to file Form 8300 is intentional, the

MORE

civil penalty increases to $100 per failure, without the $50,000 annual limitation. Any taxpayer who willfully fails to file Form 8300 may be subject to a criminal fine of not more than $25,000 -- $100,000 in the case of a corporation -- and imprisonment for up to one year.

Forms can be obtained from the appropriate IRS Forms Distribution Center.

X X X

EXHIBIT "C"

Calendar No. 537

98th Congress
1st Session

SENATE

Report No.
98-300

OMNIBUS RECONCILIATION ACT OF 1983

REPORT

OF THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

TO ACCOMPANY

S. 2062

A BILL TO PROVIDE FOR RECONCILIATION PURSUANT TO SECTION 3 OF THE FIRST CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1984 (H. CON. RES. 91, NINETY-EIGHTH CONGRESS)

together with

ADDITIONAL VIEWS

November 4, 1983.—Ordered to be printed

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allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement, must maintain customer lists. These lists must show the name, address, and taxpayer identification number of each person investing in each plan or arrangement which the person organizes or sells. In addition, the Secretary is given authority to require such other information as he finds necessary. These lists must enable the Secretary to identify every purchaser of a given type of investment scheme. To this end, the Secretary may require the promoter to maintain these lists by reference to specific identifying characteristics relating to their purported tax treatment. These requirements do not apply with respect to partnership interests or subchapter S share ownership because such arrangements are already subject to special audit rules under the Code. Information must be retained for seven years after it is first required to be listed.

If the Secretary determines that the list requirement of this new provision is inconsistent with, or redundant vis-a-vis, any other provision of the Code, he may provide appropriate exceptions to the list requirement. Similarly, he may provide rules to eliminate maintenance of duplicate lists under this provision.

Any promoter or salesman who is required to maintain lists under the new provisions of the bill will be subject to a penalty comparable to that imposed on income tax return preparers who fail to maintain required lists. Thus, each failure to retain a record of any particular purchaser of an investment, will be subject to a $50 penalty except when the failure results from reasonable cause and not from willful neglect. Unlike the return preparer penalty, however, the penalty for failure to maintain required promoter lists is not subject to an aggregate annual limitation.

Effective Date

This list requirement applies to investments sold after December 31, 1983.

2. Reporting with Respect to Cash Transactions and Mortgage Interest (sec. 122 of the bill and new sec. 6050H of the Code)

Present Law

Cash transactions.—In addition to the information reporting required by the Code, the Bank Secrecy Act authorizes the Secretary to require reporting of certain financial transactions. Under these rules, certain banks and other financial institutions are required to report cash transactions (including deposits and withdrawals) of more than $10,000. The Treasury regulations provide a number of exceptions to this reporting requirement. Also, persons who bring or send more than $5,000 in cash or other bearer instruments into or out of the United States must report the event to the United States Customs Service. Finally, a United States taxpayer who files a tax return is required to notify the Internal Revenue Service, where provided for on the tax return, of the existence of a foreign bank account or other foreign financial account that he controls or in which he has an interest. If the amount in the account exceeds $1,000, then the amount must be reported on a separate form to the Treasury Department.

Bank Secrecy Act information is compiled by the Treasury Department, and made available to agents of the Internal Revenue Service.

Mortgage interest.—Under present law, interest paid on a mortgage is deductible in computing taxable income. There is, however, no requirement that the recipients of such interest provide information with respect to the payment to the Internal Revenue Service.

Reasons for Change

The committee is concerned that approximately 89 percent of the revenue lost through noncompliance is attributable to the underreporting of income. For 1981, the Internal Revenue Service estimates that taxpayers filing returns failed to report $134 billion of income and nonfilers failed to report $115 billion. This $250 billion of underreporting reduced tax receipts by an estimated $85 billion. Unreported income connected with illegal activities was estimated to result in an additional $9 billion of lost revenue. The committee believes that reporting on the spending of large amounts of cash will enable the Internal Revenue Service to identify taxpayers with large cash incomes.

In addition, the committee believes that a provision requiring recipients of mortgage interest payments in excess of $2,300 to report the interest received to the Internal Revenue Service (with a copy to the payor) will materially assist the Internal Revenue Service in verifying the accuracy of claimed mortgage interest deductions. Internal Revenue Service studies indicate that a significant percentage of all overstated deductions involves overstatement of interest deductions.

Explanation of Provision

Cash transactions.—Under the bill, any person who receives (for his own account or the account of another) cash in connection with a trade or business will be required to report on any transaction in which the amount of this cash received is $10,000 or more. A transaction subject to reporting is any receipt of cash including receipt in connection with the purchase of goods or services, the purchase or exchange of property, the opening of a deposit or credit account, the purchase of gambling chips, or any similar transaction. For this purpose, a series of related transactions will be treated as a single transaction.

This new reporting requirement is imposed with respect to any receipt of cash in connection with a trade or business whether or not the receipt constitutes income in the trade or business. Thus, reporting is required whether or not consideration is returned for the cash and whether or not the cash is received for the recipients' account or for the account of another. An exception is provided in the case of transactions subject to reporting under the Bank Secrecy Act.

The recipient of the cash will be required to report the name, address, and identifying number of the payor, the date and nature of the transaction and such other information as the Secretary may require. In addition to furnishing reports on each cash transaction to the Internal Revenue Service, the recipient of the cash must furnish each payor an annual statement aggregating the amounts of cash received from him. Such statement must be furnished on or before January 31 of the year following the year of the reportable event.

The bill defines cash for purposes of this provision as including only U.S. and foreign currency.

Mortgage interest.—Under the bill, any person who, in connection with a trade or business, receives $2,300 or more of mortgage interest payments from any person during the calendar year will be required to report the payor's, name, address, and taxpayer identification number and such other information as the Secretary may prescribe. This reporting requirement applies not only to the person entitled to the interest, but also to persons (such as service companies) who receive interest payments on behalf of another. For this purpose, mortgage interest is any interest on an obligation secured by an interest in real property (including, however, interest payable under a contract for deed) and amounts paid in lieu of interest for which a deduction is allowed. In addition to furnishing reports on mortgage interest receipts of $2300 or more for any calendar year to the Internal Revenue Service, the payment recipient must furnish to each payor an annual statement of the amount of mortgage interest received from that payor in the calendar year. Such statements are due on or before January 31 of the year following the calendar year for which the return is made.

The committee decided to require reporting only where the amount of interest exceeds $2,300 because payments in excess of that amount generally allow individual payors to claim itemized deductions.

Penalties.—The penalty for failure to make required reports will be similar to that imposed on failures to make other information reports. Thus, the penalty will be $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply.

Effective Date

This new reporting requirement will apply to amounts received after December 31, 1982.

3. Tax Court Small Tax Case Provision (sec. 123 of the bill and sec. 7463 of the Code)

Present Law

Under present law, taxpayers using the "small tax case" procedure may appear pro se or be represented by any person admitted

EXHIBIT "D"

tary may, if he considers it appropriate, provide for an exception from reporting for interest paid on credit cards that are secured by real property. This exception would be appropriate if the Secretary determines that such interest is most likely to show on returns as interest on credit cards rather than home mortgage interest. The conferees do not intend that the Secretary except from reporting interest that is reported on Schedule A as home mortgage interest. The agreement also provides the Secretary with authority to issue regulations to eliminate duplicative reports.

The conferees anticipate that recipients of mortgage interest will require the payor to furnish his taxpayer identification number as part of the mortgage loan approval or closing process for mortgage loans entered into after December 31, 1984.

With respect to mortgage loans in existence on December 31, 1984, the conferees anticipate that the Secretary will require recipients of mortgage interest to request, at least once a year, from each payor the payor's taxpayer identification number, unless the recipient already has the payor's number in its accounting system. The conferees anticipate that the Secretary will permit these requests for a payor's taxpayer identification number to be included in the recipient's regular mailings of either payment coupon booklets or annual statements to the payor. Recipients will not be required to make separate mailings of these requests, unless the recipient does not otherwise contact the payor at least once each calendar year. The conferees anticipate that the first request will be made as soon as practicable, but in no event later than with the first mailing by the recipient to the payor in 1985. The conferees also anticipate that recipients will notify payors that the Internal Revenue Service requires the payor to furnish its taxpayer identification number in order to verify the payor's deduction for mortgage interest and that the payor is subject to a $50 penalty by the Internal Revenue Service if the payor fails to furnish its taxpayer identification number. If the interest recipient makes the annual requests described above, and properly and promptly processes the responses, it will not be subject to any penalty for failure to include a TIN on its information return to the Internal Revenue Service because the payor's failure to supply the requested number will constitute reasonable cause for failure to supply the number to the Internal Revenue Service.

The conferees intend that the Secretary coordinate the requirement that a statement be furnished to the payor under this provision with other requirements, such as those of Federal mortgage programs, that similar statements be furnished, so that duplicative reporting is minimized.

b. Returns relating to cash received in a trade or business

Present law

Under the Bank Secrecy Act, certain banks and other financial institutions are required to report cash transactions of more than $10,000.

House bill

No provision.

[page 988]

Senate amendment

A person engaged in a trade or business who receives, in the course of the trade or business, $10,000 or more in cash or foreign currency in one or more related transactions must report it to the Internal Revenue Service and provide a statement to the payor. Amounts required to be reported under the Bank Secrecy Act are excepted from this reporting requirement. Present law penalties for other failures to file information returns and statements apply (generally, $50 per failure except in cases of intentional disregard). The provision is effective for amounts received after December 31, 1984.

Conference agreement

The conference agreement generally follows the Senate amendment. Thus, reporting is required only for payments of more than $10,000 that are received by a person in the course of his trade or business. Reporting is not required on payments (a) that are received in a transaction reported under the Bank Secrecy Act if the Secretary determines that the report under this provision would duplicate the report under Bank Secrecy, or (b) that are received by certain specified financial institutions within the meaning of the Bank Secrecy Act.

With respect to these specified financial institutions, the conferees do not intend to affect the detailed reporting rules and exceptions which Treasury has developed. The other categories of financial institutions that are not specified as exempt from reporting under this provision have generally been exempted by Treasury from Bank Secrecy reporting. Examples of these other entities are certain dealers in precious metals, stones, or jewels, pawnbrokers, loan or finance companies, insurance companies, and travel agencies. These entities are required to report under this new provision. To the extent that Treasury also requires that they report transactions under Bank Secrecy, the Secretary can provide that duplicative reports that would be made on those transactions pursuant to this provision need not be made.

The conferees understand that the Treasury is considering extending certain Bank Secrecy Act reporting to casinos and other establishments. To avoid duplicative reporting requirements, the Secretary has discretion under the conference agreement and the Bank Secrecy Act to review the obligations imposed under the Bank Secrecy Act and to eliminate any reporting required under the conference agreement if the Bank Secrecy reporting, in substance, provides for the reporting of transactions required to be reported under the conference agreement with respect to the information that must be provided to the Treasury.

Under this provision, any taxpayer required to report under this provision who is in a trade or business and who, in the course of the trade or business, receives more than $10,000 in cash in one or more related transactions must report those transactions. For example, assume that an individual purchases a $8,000 item and a $1,500 item at an auction. The auction house adds a 10% buyer's premium and the local sales tax, at a 5% rate. The taxpayer pays his $10,972.50 bill in cash. The auction house must report on that transaction. The auction house could not avoid the reporting requirement by presenting two separate bills of $9,240 and $1,732.50.

c. Provisions relating to individual retirement accounts

Present law

The trustee of an IRA is required to report to the IRS and to the owner of the IRA on contributions or withdrawals made. Each failure to provide a report on a contribution or withdrawal is subject to a $10 penalty. Contributions must be made by the due date (including extensions) of the return for the year to which the contributions relate.

House bill

The report must identify the years to which IRA contributions relate, effective for contributions made after April 15, 1984, relating to years beginning after December 31, 1983. The penalty is increased to $50 for each failure to provide a report on contributions or withdrawals, effective on the date of enactment.

Senate amendment

The report must identify the years to which IRA contributions relate effective for contributions made after 30 days after enactment for taxable years beginning after December 31, 1983. The penalty is increased to $50 for each failure to provide a report on contributions or withdrawals, effective on the date of enactment. Contributions must be made by the due date of the return (without extensions), effective for contributions made more than 30 days after the date of enactment, for taxable years beginning after December 31, 1983

Conference agreement

The conference agreement follows the Senate amendment, except that the provision is effective for contributions made after December 31, 1984. The conferees wish to clarify that the trustee may require that the owner of the IRA certify as to which year a contribution relates and that, except in unusual circumstances, the trustee may rely on that certification.

The date by which this report must be provided to the Internal Revenue Service and the periods to which the report relates are to be specified by the Secretary in regulations. The conferees intend that generally trustees will be required to report only once a year on the cumulative total of contributions relating to a particular taxable year. The Secretary may, however, provide for more frequent reporting if he determines that it is appropriate to do so. As to the date by which the report must be provided to the Internal Revenue Service, the Secretary could, for example, require reporting by the end of May on all IRA contributions relating to the taxable year with respect to which the individual's tax return was due on the preceding April 15.

EXHIBIT "E"

Form **8300** (Rev.)
(Rev. January 1985)
Department of the Treasury
Internal Revenue Service

Report of Cash Payments Over $10,000 Received in a Trade or Business

OMB No. [illegible]
Expires [illegible]

Part I Individual or Organization for Whom This Transaction Was Completed

Individual's last name	First name	M.I.	Social security number
Name of organization	Employer identification number	Passport number	Country
Number and street	Business or occupation	Alien registration number	Country
City / State	ZIP code / Country (if not U.S.)	Other identifying data (Specify)	

Part II Identity of Individual Conducting the Transaction (Complete only if an agent conducts a transaction for the person in Part I)

Last name	First name	M.I.	Social security number
Number and street	Passport number / Country	Alien registration number	Country
City / State	ZIP code / Country (if not U.S.)	Other identifying data (Specify)	

Part III Description of Transaction and Method of Payment

1 Amount of cash received $

2 Amount in item 1 in $100 bills $

3 Nature of transaction

Description of property or service

a ☐ personal property purchased

b ☐ real property purchased

c ☐ personal services provided

d ☐ business services provided

e ☐ intangible property purchased

f ☐ debt obligation paid

g ☐ exchange of cash

h ☐ escrow or trust funds

i ☐ other (specify) ▶

4 Method of payment by customer
a ☐ paid with U.S. currency or coin
b ☐ paid with foreign currency (describe) ....

5 Date paid

Part IV Business Reporting This Transaction

Name of reporting business		Identification number (EIN or SSN)
Street address		Nature of your business
City	State / ZIP code	

Under penalties of perjury, I declare that the information I have furnished above, to the best of my knowledge, is true, correct, and complete.

SIGN HERE ▶ ______________________ ______________________ ______________________
(Authorized Signature—See Instructions) (Title) (Date)

For Paperwork Reduction Act Notice, see page 2.

Form **8300** (Rev. 1-85)

General Instructions

Paperwork Reduction Act Notice.—The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you are required to provide it to us. The requested information is useful in criminal, tax, and regulatory investigations. In addition to directing the Federal Government's attention to unusual or questionable transactions, the reporting requirement discourages the use of currency in illegal transactions. Any person engaged in a trade or business is required to provide the information under Section 6050 I of the Internal Revenue Code.

Who Must File.—Each person engaged in a trade or business who, in the course of such trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) must file Form 8300. For example, multiple receipts of cash from any person which in any one day total more than $10,000 should be treated as a single receipt (and therefore reportable).

Certain precious metals dealers, precious stones dealers, jewelry dealers, pawnbrokers, loan or finance companies, insurance companies and travel agencies are not excepted and must file Form 8300 when they have reportable cash transactions. To the extent that the Assistant Secretary of the Treasury (Enforcement and Operations) requires these financial institutions to file Form 4789, Currency Transaction Report, Form 8300 is not required to be filed for the same transaction(s).

Exceptions.—Financial institutions who are required to file IRS Form 4789 under Section 5312(a)(2)(A), (B), (C), (D), (E), (F), (G), (J), (K), (R), and (S) of Title 31, U.S.C., are excepted from filing Form 8300. These financial institutions include each agency, branch, or office in the United States of any person doing business in one or more of the capacities listed below:

(1) a bank (see Definitions);

(2) a broker or dealer in securities, registered or required to be registered with SEC under the Securities Exchange Act of 1934;

(3) a person who engages as a business in dealing in or exchanging currency (for example, a dealer in foreign exchange or a person engaged primarily in the cashing of checks);

(4) a person who engages as a business issuing, selling, or redeeming traveler's checks, money orders, or similar instruments, except one who does so as a selling agent exclusively, or as an incidental part of another business;

(5) a licensed transmitter of funds, or other person engaged in the business of transmitting funds abroad for others.

Transactions entirely occurring outside the United States are excepted from these reporting requirements, except to the extent regulations provide otherwise. The United States includes the 50 states and the District of Columbia.

When and Where to File.—File this form by the 15th day after the date of the transaction with the Internal Revenue Service Data Center, P.O. Box 32621, Detroit, MI 48232 ATTN: NCP or hand carry it to your local IRS office. Keep a copy of each Form 8300 for 5 years from the date you file it.

Identifying Number.—For individuals this is the social security number. For others it is the Federal employer identification number (EIN), which has 9 digits. For aliens or other non-U.S. individuals use the passport number or alien registration number and indicate the country.

Penalties.—Civil and criminal penalties are provided for failure to file a report or to supply information, and for filing a false or fraudulent report.

Statement to be provided.—A written statement must be provided to each person named in this form. The statement must be provided on or before January 31 of the year following the calendar year in which the report is made. The statement must show the name and address of the business receiving the cash and the total amount of cash received during the year from the payer and that the information is being furnished to the IRS. Keep a copy for your records. A copy of the Form 8300 that was filed with the Internal Revenue Service may be used as the statement if the payer had a single transaction for the year.

Specific Instructions

Part I

(1) For individuals, enter last name, first name, and middle initial, if any, in the name block in that order. For other than an individual, enter the complete organization name, address, and employer identification number in the boxes provided.

(2) In the social security block, enter the social security number of the individual conducting the transaction. If the individual has no number, write "None" in this block.

(3) If the individual is an alien or foreign national, enter the alien registration number or passport number and country or other official documents evidencing nationality or residence in the boxes provided.

(4) Complete the "Other identifying data" box for individuals other than aliens and foreign nationals. Other identifying information includes documents normally acceptable as a means of identification when cashing checks (e.g., a driver's license or credit card number may be entered in the "Other identifying data" box provided).

Part II

(1) In the address section, enter the permanent street address of the individual agent of the person in Part I conducting the transaction.

(2) In the social security block, enter the social security number of the individual conducting the transaction. If the individual has no number, write "None" in this block.

(3) If the individual is an alien or foreign national, enter the alien registration number or passport number and country or other official documents evidencing nationality or residence in the boxes provided.

(4) Complete the "Other identifying data" box for individuals other than aliens and foreign nationals. Other identifying information includes documents normally acceptable as a means of identification when cashing checks (e.g., a driver's license or credit card number may be entered in the "Other identifying data" box provided).

Part III

Enter in item 2 the amount of U.S. currency included in item 1 that is in $100 bills or higher. (For example, if the amount in item 1 is $30,000, and $25,000 of it was paid in $100 bills, enter $25,000 in item 2).

Check the applicable boxes that describe the nature of the transaction. Briefly describe the kind of property or service for which the customer paid cash.

If the aggregate amount of cash received in 2 or more installment payments exceeds $10,000, the date entered in item 5 should be the date the payment is made that caused the aggregate amount of cash to exceed $10,000.

Part IV

Signature.—This report must be signed by an authorized individual. Also type or print the name of the authorized signer below the signature.

Definitions

Bank.—Each agent, agency, branch, or office in the United States of a foreign bank and each agency, branch, or office in the United States of any person doing business in one or more of the capacities listed below:

(1) a commercial bank or trust company organized under the laws of any state or of the United States;

(2) a private bank;

(3) a savings and loan association or a building and loan association organized under the laws of any state or of the United States;

(4) an insured institution as defined in section 401 of the National Housing Act;

(5) a savings bank, industrial bank, or other thrift institution;

(6) a credit union organized under the laws of any state or of the United States; and

(7) any other organization chartered under the banking laws of any state and subject to the supervision of the bank supervisory authorities of a state.

Person.—An individual, corporation, partnership, trust or estate, joint stock company, association, syndicate, joint venture, or other unincorporated organization or group, and all entities treated as legal personalities, including organizations that are exempt from tax.

Cash.—The coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued. It includes United States silver certificates, United States notes, and Federal Reserve notes, but does not include bank checks, traveler's checks, or other negotiable or monetary instruments customarily accepted as money.

Transaction in Cash.—A transaction involving the physical receipt of cash from a person. A transaction in cash does not include a receipt of funds by means of bank check, bank draft, wire transfer, or other written order that does not include the physical transfer of cash.

Transaction.—The purchase of goods, services, personal or real property, and intangible property by a customer; a debt obligation paid for with cash; the receipt and conversion of cash to a negotiable instrument (for instance, a receipt of cash from a person in exchange for a check); and the receipt of cash to be held in escrow or trust.

☆ U.S. GOVERNMENT PRINTING OFFICE: [illegible]

EXHIBIT "F"

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8025]

Income Tax; Taxable Years Beginning After December 31, 1953; OMB Control Numbers Under the Paperwork Reduction Act; Returns Relating to Cash in Excess of $10,000 Received in a Trade or Business

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the requirement of reporting cash in excess of $10,000 received in a trade or business. Changes to the applicable law were made by the Tax Reform Act of 1984. The regulations affect any person who, in the course of a trade or business in which such person is engaged, receives cash in excess of $10,000 in 1 transaction (or 2 or more related transactions). The regulations provide these persons with the guidance necessary to comply with the law. In addition, the text of the temporary regulations set forth in this document serves as the text of the proposed rulemaking in the Proposed Rules section of this issue of the Federal Register.

DATES: The regulations apply to cash payments received after December 31, 1984, and are effective May 23, 1985.

FOR FURTHER INFORMATION CONTACT: Bruce H. Jarist of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3238 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary regulations relating to the reporting of cash in excess of $10,000 received in a trade or business under section 6050I of the Internal Revenue Code of 1954, as added by section 146 of the Tax Reform Act of 1984 (98 Stat. 685). The regulations provide that any person engaged in a trade or business who receives, in the course of that trade or business, cash in excess of $10,000 in 1 transaction (or 2 or more related transactions) must file an information return with respect to that transaction. The regulations also provide that a person who makes an information return must furnish a statement to each person identified on the return. The temporary regulations will remain in effect until superseded by final regulations on this subject. The regulations are issued under the authority of sections 6050I and 7805 of the Internal Revenue Code of 1954 (98 Stat. 685 26 U.S.C. 6050I; 68 Stat. 917, 26 U.S.C. 7805).

Explanation of Provisions

Section 6050I provides that an information return must be made by any person engaged in a trade or business who receives, in the course of that trade or business, cash in excess of $10,000 in 1 transaction (or 2 or more related transactions). The return must be filed with the Service by the 15th day following the date of receipt of the reportable cash payment. Any person required to make an information return under section 6050I must also furnish a statement to any person identified on the return showing the aggregate amount of reportable cash received from that person. The statement must be furnished on or before January 31 of the year following the calendar year in which the cash is received.

Section 6050I(c)(1)(A) provides that the reporting requirements of section 6050I will not apply to cash received in a transaction reported under Title 31 of the United States Code if the Secretary determines that reporting under section 6050I would duplicate the reporting to the Treasury under Title 31. On February 6, 1985, final regulations effective on May 7, 1985, which classify casinos with gross annual gaming revenue in excess of $1,000,000 as financial institutions subject to reporting and recordkeeping requirements of the

Bank Secrecy Act provisions of Title 31, were published in the Federal Register (50 FR 5065). In light of the issuance of the Title 31 regulations, special rules are provided with respect to cash received by casinos with gross annual gaming revenue in excess of $1,000,000.

Although these temporary regulations require attorneys to report with respect to the receipt of cash in excess of $10,000, the Service will entertain comments from the legal community concerning the possibility of developing an exception to the reporting requirement for information on transactions which might fall within the scope of the attorney-client privilege.

Because of the January 1, 1985, effective date of section 6050I, there is a need for immediate guidance. Therefore, these regulations have been drafted in question and answer format in order to facilitate their timely publication. No inference should be drawn, however, regarding issues not raised herein or regarding the inclusion of certain questions, and not others, in these regulations.

Executive Order 12291, Regulatory Flexibility Act, and Paperwork Reduction Act

The Commissioner of the Internal Revenue has determined that this regulation is not a major rule as defined in Executive Order 12291, or the Treasury and OMB implementation of the Order dated April 29, 1983. No general notice of proposed rulemaking is required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act does not apply and a Regulatory Impact Analysis is not required for this rule. The collection of information requirements contained in these regulations have been approved by the Office of Management and Budget (OMB) under section 3507 of the Paperwork Reduction Act.

List of Subjects in 26 CFR 1.6001—1.6109-2

Income taxes, Administration and procedure, Filing requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 and Part 602 are amended as follows:

PART 1—[AMENDED]

Income Tax Regulations

Paragraph 1. These regulations are issued under the authority contained in 26 U.S.C. 7805 and 26 U.S.C. 6050I. The authority citation for Part 1 is amended by adding, "§ 1.6050I–1T also issued under 26 U.S.C. 6050I."

Par. 2. The following new § 1.6050I–1T shall be added at the appropriate place.

§ 1.6050I–1T Returns relating to cash in excess of $10,000 received in a trade or business (Temporary).

The following questions and answers relate to the requirement of reporting cash in excess of $10,000 received in a trade or business under section 6050I of the Internal Revenue Code of 1954, as added by section 146 of the Tax Reform Act of 1984 (98 Stat. 685).

In General

Q–1: What does section 6050I require with respect to the reporting of cash received in a trade or business?

A–1: Section 6050I requires that an information return must be made by any person (as defined in section 7701 (a)(1)) who, in the course of a trade or business in which such person is engaged, receives cash in excess of $10,000 in 1 transanction (or 2 or more related transactions). For purposes of these questions and answers the person receiving the cash is referred to as the "recipient."

Q–2: What is the definition of "cash"?

A–2: "Cash" is the coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued. Cash includes United States silver certificates, United States notes, and Federal Reserve notes, but does not include bank checks, traveler's checks, bank drafts, wire transfers or other negotiable or monetary instruments not customarily accepted as money.

Trade or Business Requirement

Q–3: Under what circumstances is a person considered to be engaged in a trade or business?

A–3: For purposes of this section, a person is engaged in a trade or business if such person is engaged in a trade or business within the meaning of section 162 of the Internal Revenue Code of 1954.

Q–4: Must cash in excess of $10,000 which is not received in the course of a person's trade or business be reported?

A–4: No. The receipt of cash in excess of $10,000 by a person, other than in the course of the person's trade or business, is not reportable. Thus, for example, an individual in the trade or business of selling real estate need not report the receipt of cash in excess of $10,000 arising from the sale of the individual's motorboat, if the motorboat was not used in any trade or business in which such individual was engaged. For purposes of this section, any cash received in a transaction by a corporation is considered to be received in connection with a trade or business in which the corporation engages.

Q–5: Must cash in excess of $10,000 which is received by a service provider (such as an attorney, accountant, financial advisor, architect, engineer, or doctor) from a client be reported?

A–5: Yes. The receipt of cash in excess of $10,000 by a service provider from a client as payment for services rendered, or as reimbursement for expenses incurred in connection with the performance of services, must be reported in accordance with this section. In addition, as discussed in A–6 of this section, the receipt of cash in excess of $10,000 by a service provider from a client for use on behalf of the client (such as in establishing a trust fund for the benefit of the client or the client's designee) must be reported.

Q–6: Must cash in excess of $10,000 received by a person for the account of another person be reported?

A–6: Yes. The requirements of this section apply regardless of whether cash is received for the recipient's own account or for the account of another person. For example, a person who collects delinquent accounts receivable for an automobile dealer must report with respect to the receipt of cash in excess of $10,000 from the collection of a particular account whether the cash is received for the collector's own account (*i.e.*, where the collector has purchased the delinquent account from the automobile dealer at a discount), or for the account of the automobile dealer (*i.e.*, where the rights to the proceeds from the account are retained by the automobile dealer and the collection is made on a fee-for-service basis).

Q–7: Must cash in excess of $10,000 received by an agent from its principal be reported?

A–7: A person engaged in a trade or business, who in connection with such trade or business acts as an agent (or in some other similar capacity) and receives cash in excess of $10,000 from a principal, must report with respect to the receipt of cash in accordance with this section unless the following exception applies. An agent who receives cash from a principal and uses the cash within 15 days in a cash transaction (the "second cash transaction") which is reportable under section 6050I or section 5312 of Title 31 of the United States Code and the regulations under section 5312 (31 CFR Part 103), and who discloses the name, address, and taxpayer identification number of the principal to the recipient in the second cash transaction need not report with respect to the initial receipt of cash from the principal. For example, if a person (the "principal") gives an attorney $75,000 in cash to purchase real property on behalf of the principal, and within 15 days the attorney purchases the property for cash from a real estate developer and discloses to the real estate developer the principal's name, address, and taxpayer identification number, the attorney need not report the initial receipt of $75,000 in cash. If, however, the attorney pays for the property by means other than cash, or effects the purchase more than 15 days following receipt of the cash from the principal, or fails to disclose the principal's name, address, and taxpayer identification number (assuming the agent does not know that the recipient has the principal's address or taxpayer identification number), or purchases the property from a person not engaged in a trade or business, then the attorney would be required to report with respect to the initial receipt of $75,000 in cash from the principal. An agent will be deemed to have met the disclosure requirements of this paragraph if the agent discloses only the name of its principal and the agent knows that the recipient has the principal's address and taxpayer identification number.

Transactions Subject to Reporting

Q–8: What is a "transaction" for purposes of this section?

A–8: For purposes of this section a transaction is the underlying event precipitating the payer's transfer of cash to the recipient. A transaction may be (but is not limited to) a sale of goods or services; a sale of real property; a sale of intangible property; a rental of real or personal property; an exchange of cash for other cash; the establishment or maintenance of or contribution to a custodial, trust, or escrow arrangement; a payment of preexisting debt; a conversion of cash to a negotiable instrument; or the making or repayment of a loan.

Q–9: Can single transactions be divided into multiple transactions?

A–9: (a) No. A single transaction may not be divided into multiple transactions in order to avoid reporting under this section.

(b) The following examples illustrate the application of the principle of this A–9:

Example 1. A person has a tacit agreement with a gold dealer to purchase $36,000 in gold bullion. The reporting requirement of this section cannot be avoided by recasting the single sales transaction into 4 separate $9,000 sales transactions.

Example 2. An attorney agrees to represent a client in a criminal case with the attorney's fee to be determined on an hourly basis. In the first month in which the attorney represents the client, the bill for the attorney's services comes to $8,000, which the client pays in cash. In the second month in which the attorney represents the client, the bill for the attorney's services comes to $4,000, which the client again pays in cash. The aggregate amount of cash paid ($12,000) relates to a single transaction, the sale of legal services relating to the criminal case, and must be reported under the provisions of this section.

Example 3. A person has an intention of contributing a total of $45,000 to a trust fund, and the trustee of the fund knows or has reason to know of that intention. The reporting requirement of this section cannot be avoided by the person making five separate $9,000 cash contributions to a single fund or by making five $9,000 cash contributions to five separate funds administered by a common trustee.

Q–10: What are "related transactions"?

A–10: Any transactions conducted between a payer (or its agent) and a recipient in a 24-hour period are related transactions, and must be aggregated and reported as a single transaction (if the aggregate amount exceeds $10,000). Thus, for example, if an individual attends a one-day auction and purchases two items, at a cost of $9,240 and $1,732.50 respectively (tax and buyer's premium included), the auction house is required to report the aggregate amount of cash received from the related sales ($10,972.50), even though the auction house accounts separately on its books for each item sold and presents the purchaser with separate bills for each item purchased. In addition to the general rule stated in the first sentence of this A–10, transactions conducted between a payer (or its agent) and a recipient during a period of more than 24 hours are related if the recipient knows or has reason to know that each transaction is one of a seried of connected transactions. For example, if a coin dealer makes a cash sale of $9,000 worth of gold coins to the same person on each of three successive days, the three $9,000 transactions are related transactions aggregating $27,000 if the dealer knows, or has reason to know, that each transaction is one of a series of connected transactions.

Q–11: Are separate departments of a business treated as a single recipient for purposes of aggregating the cash payments received by each?

A–11: For purposes of these questions and answers, each store, division, branch, department, headquarters, or office ("branch") (regardless of physical location) comprising a portion of a person's trade or business shall be deemed to be a separate recipient, unless the branch that receives a cash payment (or a central unit linking such branch with other branches) would in the ordinary course of business have reason to know the identify of payers making cash payments to other branches of such person. For example, assume that N, an individual, purchases regulated futures contracts worth $7,500 and $5,000, respectively, through two different branches of Commodities Broker X on the same day. N pays for each purchase with cash. Each branch of Commodities Broker X transmits the sales information regarding each of N's purchases to a central unit of Commodities Broker X (which settles the transactions against N's account). Commodities Broker X must report with respect to the two related regulated futures contracts sales in accordance with this section.

Q–12: How are multiple payments relating to the same transaction (or two or more related transactions) reported?

A–12: Cash deposits or installment payments (or other similar methods of payment of prepayment) relating to a single transaction (or two or more related transactions) are reported in three different ways depending on the size of the initial and subsequent payments. (a) If the initial payment exceeds $10,000 and any subsequent payment exceeds $10,000, the recipient must report each payment that exceeds $10,000. These payments must be reported separately (or if the payments are made less than 15 days apart, the recipient may (if it so elects) make a single report with respect to the aggregate amount of the initial and subsequent payment or payments). (b) If the initial payment exceeds $10,000 but no subsequent payment exceeds $10,000, the recipient must report with respect to the initial $10,000 payment (within 15 days after the payment is received, as required by A–10), but need not report with respect to any subsequent payment. (c) If the initial payment does not exceed $10,000, the recipient must aggregate the initial payment and subsequent payments made within one year of the initial payment until such aggregate amount exceeds $10,000, and report with respect to the aggregate amount within 15 days after receipt of the payment that causes the aggregate amount to exceed $10,000. Any subsequent payment which by itself exceeds $10,000 must be separately reported.

Exceptions to the Reporting Requirement

Q–13: Must all recipients of cash in excess of $10,000 report under this section?

A–13: No. Financial institutions, as defined in subparagraphs (A), (B), (C), (D), (E), (F), (G), (J), (K), (R), and (S) of section 5312 (a) (2) of Title 31, United States Code, are not required to report the receipt of cash exceeding $10,000 under this section.

Q–14: What are the reporting requirements of this section with respect to financial institutions defined in subparagraphs (H), (I), (L), (M), (N), (O), (P), (Q), and (T) of section 5312(a)(2) of Title 31, United States Code?

A–14: The regulations under 31 CFR Part 103 do not require these financial institutions to report currency transactions under the Bank Secrecy Act. Accordingly, these financial institutions are required to report under this section with respect to transactions in which cash in excess of $10,000 is received.

Q–15: Are casinos which report certain cash transactions to the Treasury Department under 31 CFR 103.22(a)(2) and 103.25 required to report the same transactions under section 6050I and the regulations under section 6050I?

A–15: Casinos having gross annual gaming revenue in excess of $1,000,000 will become subject to reporting and recordkeeping requirements under Title 31 of the Code of Federal Regulations, as amended by 50 FR 7065 (February 6, 1985), on May 7, 1985. Under the authority granted by section 6050I(c)(1)(A), if a casino receives cash in excess of $10,000 and is required to report the receipt of such cash directly to the Treasury Department under 31 CFR 103.22(a)(2) and 103.25 and is subject to the recordkeeping requirements of 31 CFR 103.36, then the casino is not required to make a return with respect to the receipt of such cash under section 6050I and the regulations under section 6050I. This relief from reporting under section 6050I and the regulations under section 6050I applies only to cash received in the gaming business of a casino. See A–18 of these regulations.

Q–16: Are casinos which receive an exemption, under 31 CFR 103.45(c), from reporting certain cash transactions to the Treasury Department under 31 CFR 103.22(a)(2) and 103.25, required to report such transactions under section 6050I and the regulations under section 6050I?

A–16: The determination, under the authority granted by section 6050I(c)(1)(A), whether reporting will be required under section 6050I by casinos which are granted an exemption under 31 CFR 103.45(c) will be made on a case by case basis, concurrently with the granting of such an exemption.

Q–17: What are the reporting requirements of this section with respect to casinos having gross annual gaming revenue of $1,000,000 or less?

A–17: Since casinos having gross annual gaming revenue of $1,000,000 or less are not subject to the reporting and recordkeeping requirements of 31 CFR 103.22(a)(2), 103.25, and 103.36, such casinos are not eligible for the relief described in A–15 or A–16 and must report the receipt of cash in excess of $10,000 pursuant to the general requirements of section 6050I and the regulations under section 6050I.

Q–18: Are all transactions in which a casino with gross annual gaming revenue in excess of $1,000,000 receives cash in excess of $10,000 covered by A–15 or A–16?

A–18: No. Non-gaming businesses (such as shops, restaurants, entertainment, and hotels) at casino hotels and resorts are separate trades or businesses in which the receipt of cash in excess of $10,000 is reportable pursuant to the general requirements of section 6050I and the regulations under section 6050I. For example, if Casino A receives $12,000 in cash from a customer in payment for accommodations provided to that customer at Casino A's hotel, Casino A must report with respect to that transaction under section 6050I and the regulations under section 6050I.

Q–19: Is there a reporting requirement with respect to foreign cash transactions?

A–19: Generally, there is no reporting required with respect to a cash transaction if the entire transaction occurs outside the United States (the fifty states and the District of Columbia). An entire transaction consists of both the transaction as defined in A–8 of this section and the receipt of cash by the recipient. For example, assume that an airplane dealer reaches an agreement, which is formulated in part in the United States, to sell an airplane, with delivery of and payment for the airplane to be made in Mexico. If the dealer receives cash in excess of $10,000 in connection with the sale, the dealer must report in accordance with this section. If, however, no part of the agreement to sell had been formulated in the United States, the dealer would not be required to report with respect to the transaction. See A–20.

Q–20: Is there an exception to the rule that no reporting is required with respect to entire transactions occurring outside the United States?

A–20: Yes. If any part of an entire transaction occurs in the Commonwealth of Puerto Rico or a possession or territory of the United States and the recipient of cash in that transaction is subject to the general jurisdiction of the Internal Revenue Service under Title 26 of the United States Code and the recipient receives cash in excess of $10,000, then the recipient is required to report the transaction under this section.

Time, Manner, and Form of Reporting

Q–21: When must the reports required by this section be filed with the Internal Revenue Service?

A–21: In general, the reports required by this section must be filed with the Internal Revenue Service by the later of the 15th day after the date the reportable cash payment is received or the 15th day after the date of publication of these temporary regulations. If a person elects to report one payment several independently reportable payments, received within a 15-day period (as allowed in A–12), the report must be filed with the Internal Revenue Service by the 15th day after the initial payment is received.

Q–22: What form must a recipient use to report as required by section 6050I (a) and A–1 of these regulations?

A–22: A recipient must make an information return on Form 8300, which can be obtained from any Internal Revenue Service Forms Distribution Center.

Q–23: What information must be contained in a return described in A–22?

A–23: A return of information must contain the name, address, and taxpayer identification number of the person from whom the cash was received; the name, address, and taxpayer identification number of the person on whose behalf the transaction was conducted (if the recipient knows or has reason to know that the person from whom the cash was received conducted the transaction as an agent for another person); the amount of cash received; the date and nature of the transaction; and any other information required by Form 8300.

Q–24: Must a recipient follow any procedures to ensure that the information contained in a return is complete and correct?

A–24: Yes. Before effecting any transaction with respect to which a report is required under section 6050I (a) and A–1, a recipient must verify the identity of the person from whom the reportable cash is received. Verification of the identity of a person who purports to be an alien must be made by examination of such person's passport, alien identification card, or other official document evidencing nationality or residence. Verification of the identity of any other person may be by examination of a document normally acceptable as a means of identification when cashing or accepting checks (for example, a driver's license or a credit card). In addition, a return will be considered incomplete if a recipient knows (or has reason to know) that an agent is conducting the transaction for a principal, and the return does not identify both the principal and the agent.

Q-25: Where must the recipient file the return?

A-25: A recipient must file Form 8300 by mailing it to the address shown in the instructions to the form.

Q-26: Must a recipient keep a copy of each Form 8300 that it files?

A-26: Yes. A recipient must keep a copy of each Form 8300 that the recipient files for five years from the date of filing.

Requirement of Furnishing Statements to Customers

Q-27: What statements must be furnished to persons identified on a return filed by a recipient?

A-27: Any person required to make an information return under section 6050I must furnish a single, annual, written statement to each person whose name is set forth in a return ("identified person") filed with the Internal Revenue Service.

Q-28: What information must be included on the statement?

A-28: The statement must include the following information:

(a) The name and address of the person making the return;

(b) The aggregate amount of reportable cash received by the recipient during the calendar year in all cash transactions relating to the identified person; and

(c) A legend stating that the information contained in the statement is being reported to the Internal Revenue Service.

Q-29: Must the statement be in a particular form or format?

A-29: No.

Q-30: Is the statement considered to be furnished to an identified person if it is mailed to the identified person at the identified person's last known address?

A-30: Yes.

Q-31: When is a statement required to be furnished to an identified person?

A-31: A statement is required to be furnished to an identified person on or before January 31 of the year following the calendar year in which the cash is received.

Penalties

Q-32: Are there penalties for failing to comply with the requirements of section 6050I and the regulations thereunder?

A-32: Yes. The penalty for failing to make any information return under section 6050I with respect to any identified person is provided in section 6652. The penalty for failing to furnish a statement to any identified person is provided in section 6678. Criminal sanctions also apply to willful failures to make a return under section 6050I.

Effective dates

Q-33: When is section 6050I effective?

A-33: Section 6050I is effective with respect to cash payments received after December 31, 1984.

STATEMENT OF DENNIS J. KENNY, CHAIRMAN, AD HOC GROUP OF RAILROAD PIGGYBACK EQUIPMENT SUPPLIERS AND USERS (AND VICE PRESIDENT AND GENERAL COUNSEL, TRANSAMERICA INTERWAY, INC.) NEW YORK, NY

Mr. KENNY. Thank you, Mr. Chairman. My name is Dennis Kenny. I am vice president and general counsel of Transamerica Interway, which is the nation's largest owner of railroad piggyback equipment. I am here today in my capacity as the chairman of an ad hoc group of both suppliers and railroad users of this railroad piggyback equipment. With me here today at the table is Mr. Dale Wickham of Piper & Marbury, acting as counsel to our group. Mr. Chairman, a technical defect in Code Section 4051 causes the excise tax reduction intended by Congress on railroad piggyback equipment to operate instead as a mere tax deferral.

In 1984, in recognition of the limited highway use of railroad piggybacks, Congress enacted a temporary one-year reduction in the tax from 12 percent to 6 percent. In the tax imposed by Code Section 4051, on the first retail sale of railroad piggyback equipment, while at the same time directing further study as to the appropriate rate. In paragraph 3, however, of Code Section 4051(b), the reduction is defeated. It defeats the intended rate reduction by imposing an additional 6 percent tax on the original—and I repeat original—purchase price of a railroad piggyback if it is ever used other than principally in rail service. Obviously, railroad piggybacks eventually must either be scrapped or converted to nonrailroad use, but typically not until they have been used for many years in rail service. Thus, the provision as presently drafted in the Act erroneously converts what we believe was intended to be a tax reduction to a mere tax deferral. To remedy this defect, we recommend repeal of the provision imposing the additional tax on the conversion. Such a repeal would be consistent with the treatment of other categories of equipment that are totally exempt from the tax. The statutory design and unusual use of certification requirements in the Act with respect to piggyback equipment already provides adequate protection. As an alternative, if some additional tax were deemed as needed to be retained for possible use conversion, a pair of limits both as to time and amount of additional tax should be imposed. First, no additional tax should be imposed unless the use conversion occurs before expiration of some minimum period, such as six months to two years. Second, the amount of any additional tax should be limited so that the additional tax, together with any tax previously paid, cannot exceed 12 percent of the value of the piggyback at the time of the conversion, principally the highway use. The corrective amendment should be made effective as if included in the original piggyback rate reduction provision. It is our belief that the revenue effect would be negligible. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared written statement of Mr. Kenny follows:]

Statement of Dennis J. Kenny
Chairman of An Ad Hoc Group of Suppliers and Railroad Users of Railroad Piggyback Equipment

Accompanied by Dale W. Wickham, Counsel to the Group,
and Edward D. Heffernan, Co-counsel to the Group

In Support Of An Addition To The Technical Corrections Act of 1985 (S. 814) To Make The Reduction In Rate For Railroad Piggyback Equipment Under The Federal Excise Tax Imposed On The First Retail Sale of Heavy Trucks And Trailers Operate As The Rate Reduction Intended Instead Of As a Mere Deferral

Mr. Chairman, Members of the Committee, I thank you for the opportunity to testify today in support of an addition to S. 814 to correct a technical defect in Code section 4051(d). The correction would make the reduction in rate for railroad piggyback equipment provided under the Federal excise tax on the first retail sale of heavy trucks and trailers operate as the rate reduction intended by Congress instead of as a mere deferral.

Although I am Vice-President and General Counsel of Transamerica Interway, Inc.,[*] the Nation's largest owner of railroad piggyback equipment, I am appearing here today in my capacity as chairman of an ad hoc group of suppliers of railroad piggyback equipment and railroads who use such equipment. Companies supporting the goals of the ad hoc group include, among the railroad piggyback equipment suppliers, Transamerica Interway and BRAE Corporation, and among the railroad users, the Southern Pacific Transportation Company, the Atchison, Topeka, Santa Fe Railroad Company, the Chessie System Railroad, Burlington Northern Railroad, Norfolk Southern Corporation, Chicago and Northwestern Transportation Company and Seaboard System Railroad. Accompanying me today is Mr. Dale Wickham,[*] Counsel to the ad hoc group.

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[*] Transamerica Interway, Inc., 522 Fifth Avenue, New York, New York 10036, (212) 719-9700

As background, section 4051 of the Internal Revenue Code was enacted as part of the Highway Revenue Act of 1982. The Act converted the prior law 10% manufacturers' excise tax on trucks to a 12% retail tax on heavy trucks and trailers, effective April 1, 1983. The prior tax applied to truck chassis and bodies weighing more than 10,000 pounds. The new retail tax imposed by section 4051 applies only to trucks weighing more than 33,000 pounds and trailers weighing more than 26,000 pounds.

The rationale for the change is clear: heavy trucks and trailers which make extensive use of the Nation's highways cause considerably greater damage to the highways than lighter vehicles or vehicles used primarily in non-highway functions, and are accordingly required to pay more tax for maintenance of the highways. Consistent with the Congressional purpose of restructuring and shifting the burden of the retail excise tax to the heaviest and most extensive highway users, not only was the weight threshold for imposition of the tax significantly increased; Congress also exempted many articles that are suitable for highway use but which are in fact primarily designed for use and primarily used in nonhighway functions. Included in the list of exempt articles are rail vans, trash containers, concrete mixers, and certain farm equipment.

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[*] Dale W. Wickham, Piper & Marbury, 888 16th Street, N.W., Washington, D.C. 20006, (202) 785-8150

As part of the Tax Reform Act of 1984, in recognition of the limited highway use and the preponderantly non-highway use of railroad piggyback equipment, Congress enacted (by adding a new subsection (d) to section 4051) a temporary reduction, from 12% to 6%, in the rate of tax imposed on the first retail sale of railroad piggybacks. This temporary reduction applies to sales during the 1-year period beginning July 18, 1984, and ending July 17, 1985, with direction for a study to be conducted by the Department of Transportation (in consultation with the Treasury Department) as to the appropriate application and level of the tax on railroad piggybacks, and for a report on the study, with recommendations, to be submitted to Congress by May 1, 1985.

This rate reduction applies to a trailer or semitrailer "designed for use principally in connection with trailer-on-flatcar ["TOFC"] service by rail," but only if the seller and purchaser are properly registered with the Internal Revenue Service, and then only if the purchaser certifies to the seller, at the time and in the manner required by Treasury Regulations, that the trailer or semitrailer "will be used principally" in TOFC service by rail. The certificate required by the Regulation makes clear that a false certification, in addition to other sanctions, subjects the signer to criminal penalties. Thus, the required certificate provides immediately above the signature that --

> "I understand that the willful use of this certificate to evade or defeat the excise tax otherwise applicable under section 4051(a), will subject me to a fine of not more than $10,000 or imprisonment of not more than 5 years, or both, together with cost of prosecution."

Paragraph (3) of Code section 4051(d) defeats the Congressionally intended rate reduction for railroad piggybacks by imposing an additional tax of 6% of the original purchase price of a railroad piggyback if it is at any time used or resold for use other than principally in TOFC service. There is absolutely no time limitation within which such use conversion may occur for the additional tax to be triggered. Railroad piggybacks will eventually be scrapped or resold for use other than principally in TOFC service (e.g., storage, local transportation, etc.), but typically not until they have been used for many years in TOFC service. Thus, section

4051(d) as presently drafted erroneously converts what was intended to be a tax reduction into a tax deferral.

To remedy this defect, we recommend repeal of the provision in paragraph (3) of Code section 4051(d) imposing an additional tax on use conversion. The additional tax imposed by paragraph (3) on a change in the equipment's use after the original taxable sale is not necessary, and is, in fact, punitive when compared to other excise tax exemptions or rate reductions. Thus, the seven other categories of equipment exempted from this tax under the provisions of Code section 4053 make the availability of the exemption depend on the designed use of the equipment as of the time of the taxable sale -- without even requiring a certificate of such designed use to be executed under criminal penalties. That approach has the desirable effect of eliminating the problems of enforcement for the IRS and of compliance by taxpayers that result from causing a determination that must be made at the time of the sale to be changed later on by reason of facts as to actual use after the sale. The criminal and other sanctions imposed for falsification by a purchaser of the unusual certificate required as to the intended use of a railroad piggyback should be sufficient additional protection, without adding the administrative and compliance costs and burdens associated with continuous after-sale monitoring and tax reporting on uses of equipment.

Alternatively, if some additional tax were nevertheless retained for conversion to highway use, a pair of limits on both the time for its application and its amount should be imposed to help correct the error. Thus, the time for imposition of any additional tax should be limited so that there would be no additional tax if a railroad piggyback were used principally in TOFC service by rail or other non-highway use for a significant minimum period, which could be from as little as 6 months to as much as 2 years. For example, this change in the statute could be accomplished as follows:

> Amend the first clause of paragraph (3) of Code section 4051(d) by inserting immediately after "paragraph (2)" the following: "within 1 year of the date such trailer or semitrailer is placed in service".

The amount of any additional tax also should be limited so that such additional tax, when considered together with the tax previously paid on the first retail sale of railroad piggyback, will not exceed 12% of its resale or fair market value at the time of its conversion to a disqualifying use. Such a change would achieve the proper result of limiting the imposition of the full rate of tax only to the value of the equipment at the time of its conversion to the highway uses appropriately covered by the tax. Such a limitation on the amount of any additional tax can be accomplished as follows:

> Amend subparagraph (B) of paragraph (3) of section 4051(d) to read as follows:

> "(B) the amount of the tax imposed under subsection (a) on such sale shall be equal to 12% of the amount for which the trailer is so resold (or in the case of a trailer which is not so resold but which is used for a use other than a use described in paragraph (2), 12% of the fair market value of the trailer determined at the time of such change in use), reduced (but not below zero) by the amount of tax previously imposed under subsection (a) with respect to such trailer."

To effectuate the Congressionally intended rate reduction, the corrective technical amendment should be made effective as if included in the railroad piggyback rate reduction provision upon its original enactment in 1984, so that the provision as amended applies to any sale of a railroad piggyback made after July 17, 1984.

The revenue effect of the proposed technical amendment is negligible. Railroad piggyback equipment has an estimated service life of 12 years, and is normally used in railroad service for at least 12 years. Rarely if ever would the use of such equipment be converted to nonrailroad use in less than 5 years. The entire tax expires on October 1, 1988.

As additional background, included with my statement as Attachments are:

(A) A descriptive and illustrative compilation of data and photographs entitled "Components Required on AAR Certified Railroad Piggybacks and Not Found on Over-The-Road (OTR) Trailers", and

(B) A document entitled "Comments and Legislative Recommendations Concerning Appropriate Application and Level for Railroad Piggyback Equipment of Federal Excise Tax Imposed by Internal Revenue Code Section 4051 on First Retail Sale of Heavy Trucks and Trailers".

Attachment B, in addition to recommending adoption of the technical amendment urged in this statement, recommends that the reduction in the retail excise tax rate for railroad piggybacks be made permanent -- that is, until the tax itself expires on September 30, 1988 -- at a level of not more than 3% for sales on and after July 18, 1985.

We shall be pleased to respond to any questions you may have about this.

* * *

ATTACHMENT A

COMPONENTS REQUIRED ON AAR CERTIFIED RAILROAD PIGGYBACKS AND NOT FOUND ON OVER-THE-ROAD (OTR) TRAILERS

PREPARED BY

TRANSAMERICA INTERWAY INC.

JAMES L. DAVIES
VICE PRESIDENT
TECHNICAL SERVICES

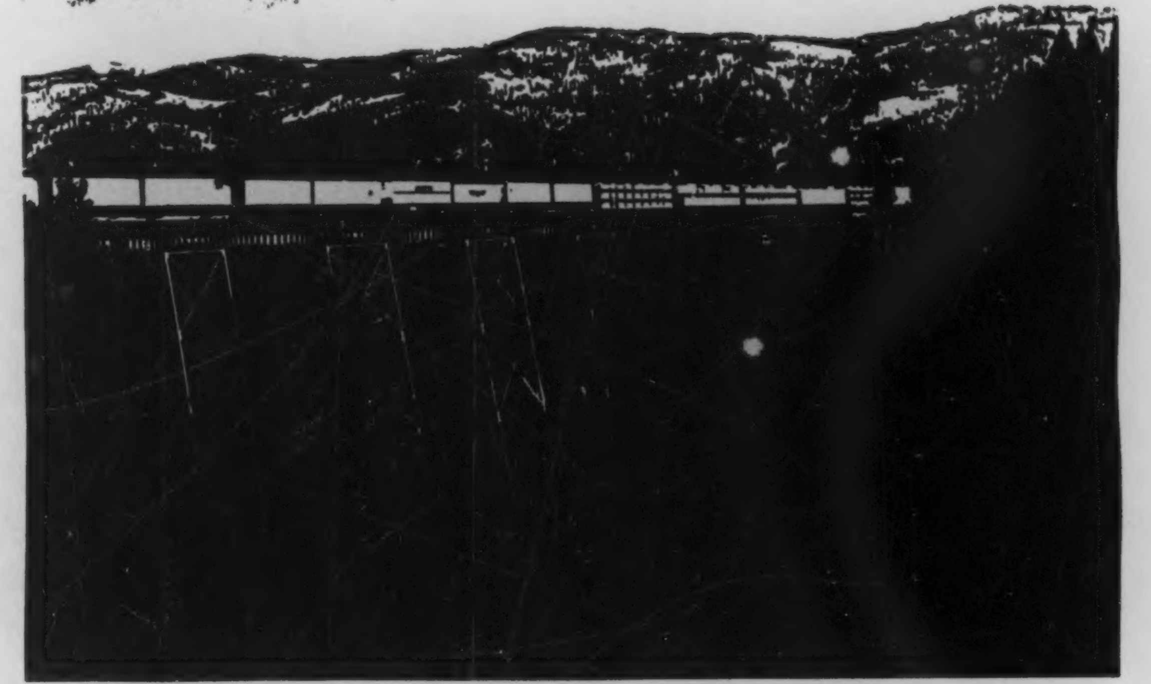
MAY 1, 1985

WEIGHT AND COST OF COMPONENTS REQUIRED ON AAR CERTIFIED RAILROAD PIGGYBACKS AND NOT FOUND ON OVER-THE-ROAD (OTR) TRAILERS

COMPONENT		REMARKS	AVE. ADDED WEIGHT	AVE. ADDED COST WITHOUT FEDERAL EXCISE TAX **
1. LIFT PADS	*	REQUIRED FOR BOTTOM RAIL PROTECTION WHEN LIFTING RAILROAD PIGGYBACK ONTO FLATCAR.	280 lbs.	$226
2. STANCHION PLATE	*	REQUIRED TO PROTECT UNDERSIDE OF RAILROAD PIGGYBACK WHEN POSITIONING IT ON FLATCAR.	55 lbs.	$ 37
3. EXTRA DOOR HARDWARE	*	4 HEAVY DUTY LOCKING BARS ON RAILROAD PIGGYBACK DOOR VS. 2 LIGHT DUTY LOCKING BARS ON OTR TRAILER DOOR.	106 lbs.	$113
4. EXTRA DOOR THICKNESS	*	1 1/4" THICK PLYMETAL DOOR WITH 10 HEAVY DUTY HINGES ON RAILROAD PIGGYBACK VS. 3/4" THICK DOOR WITH 6 HINGES ON OTR TRAILER.	165 lbs.	$265
5. FRONT CONSTRUCTION	*	HEAVY DUTY FRAME CONSTRUCTION WITH 3/4" THICK PLYWOOD LINER ON RAILROAD PIGGYBACK VS. LIGHT DUTY FRAME CONSTRUCTION AND 1/4" THICK PLYWOOD LINER ON OTR TRAILER. ALSO, FITTINGS ON RAILROAD PIGGYBACK MUST BE RECESSED AND A MANIFEST HOLDER MUST BE INSTALLED.	138 lbs.	$120
6. SIDE POSTS		HEAVY DUTY SIDE POSTS ON RAILROAD PIGGYBACK PLUS ONE EXTRA OVER LANDING GEAR AND ONE OVER TANDEM.	164 lbs.	$ 76
7. LANDING GEAR	*	HEAVY DUTY SUPPORT MEMBERS ON RAILROAD PIGGYBACK.	30 lbs.	$ 25
8. KING PIN ASSEMBLY		HEAVIER PICK-UP PLATE, HARDER KING PIN AND STRONGER SUPPORT MEMBERS ON RAILROAD PIGGYBACK.	60 lbs.	$ 51
9. SUSPENSION		4 PIN SLIDE ASSEMBLY ON RAILROAD PIGGYBACK VS. 2 PIN ASSEMBLY ON OTR TRAILER.	75 lbs.	$ 20
TOTAL			1073 lbs.	$933

* SEE PHOTOGRAPHS ON FOLLOWING PAGES.

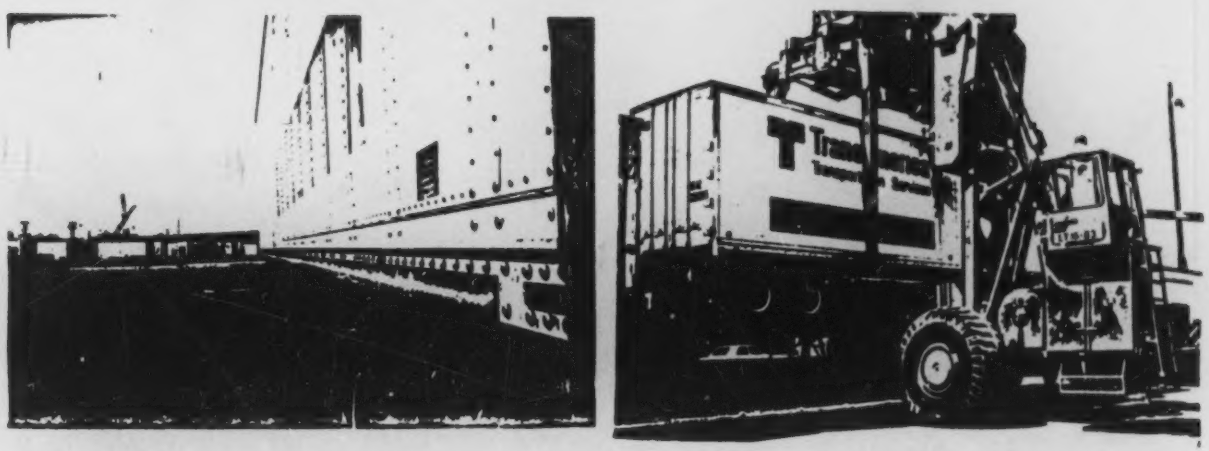
** TYPICAL COSTS SUPPLIED BY TRAILER MANUFACTURERS - COMPILED IN NOVEMBER 1984.



PAGE 2 RAILROAD PIGGYBACKS TRAVELING ON FLAT CARS

1. LIFT PADS

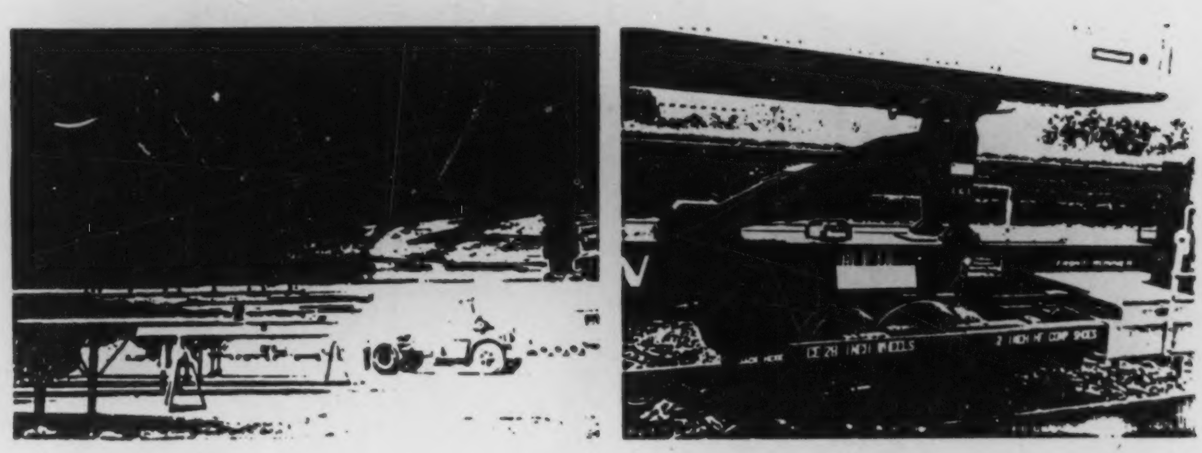
CONSIST OF STEEL ANGULAR SECTIONS FASTENED TO THE BOTTOM RAILS AND CROSS MEMBERS OF THE RAILROAD PIGGYBACKS SO AS TO PROTECT ITS BOTTOM STRUCTURE WHEN BEING LIFTED ON OR OFF A FLAT CAR BY PIGGYPACKER OR CRANE. REQUIRED FOR AAR CERTIFICATION.



(NOT REQUIRED ON OTR TRAILER)

2. STANCHION PLATE

CONSISTS OF AN 18" WIDE STEEL PLATE EXTENDING AFT OF THE KING PIN PLATE OF A RAILROAD PIGGYBACK. ITS PURPOSE IS TO PREVENT SNAGGING OF THE ADJACENT CROSS MEMBERS WHEN ENGAGING THE RAIL CAR HITCH (OR STANCHION) WITH THE RAILROAD PIGGYBACK'S KING PIN. REQUIRED FOR AAR CERTIFICATION.

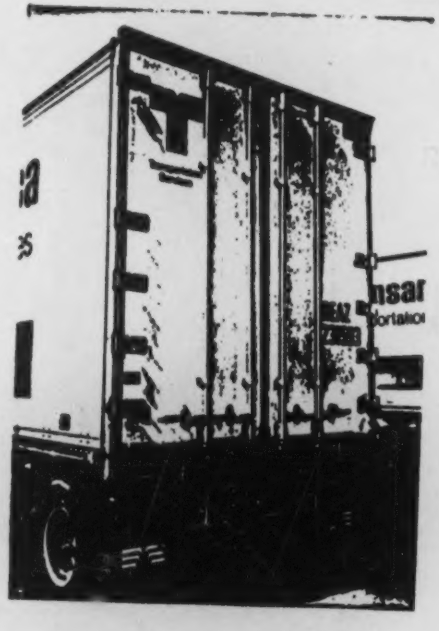


(NOT REQUIRED ON OTR TRAILER)

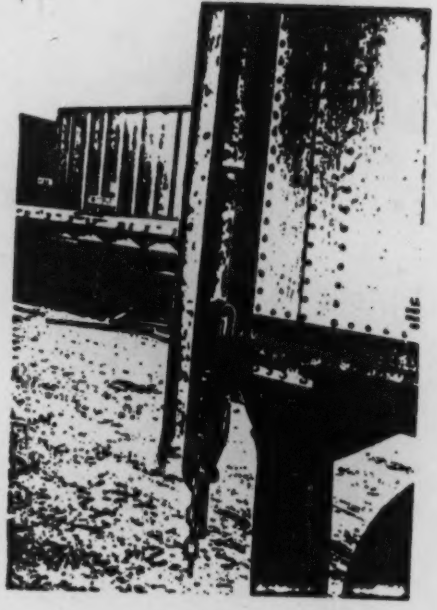
3. & 4. EXTRA DOOR HARDWARE AND DOOR THICKNESS

THE RAILROAD PIGGYBACK MUST BE BUILT TO WITHSTAND HEAVY CARGO IMPACT LOADS AT THE FRONT WALL AND REAR DOORS WHEN THE RAIL CARS ON WHICH THEY RIDE ARE BEING COUPLED OR BRAKED. THIS REQUIRES EXTRA HINGES (10) AND LOCKING BARS (4) - ALL HEAVY DUTY, AT THE REAR. ALSO AAR SPECIFIED DOOR THICKNESS MUST BE 1¼". THIS COMPARES WITH A TYPICAL OTR TRAILER HAVING LIGHT DUTY HINGES (6), LOCKING BARS (2) AND DOOR THICKNESS (3/4").

RAILROAD PIGGYBACK - REAR DOORS



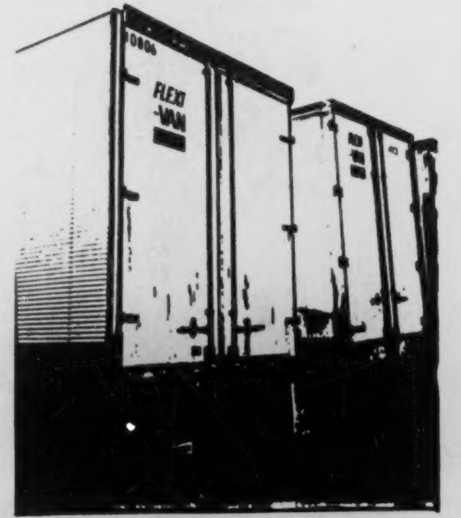
4 LOCKING BARS
10 HINGES



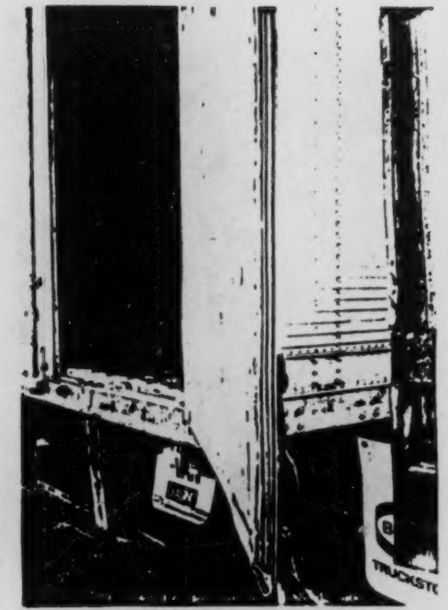
1¼" DOOR THICKNESS

3. & 4. (CONTINUED)

OTR TRAILER - REAR DOORS


10806
FLEXI
-VAN

2 LOCKING BARS
6 HINGES

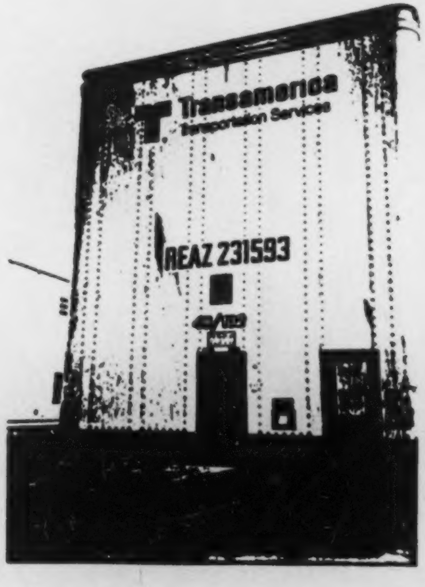


3/4" DOOR THICKNESS

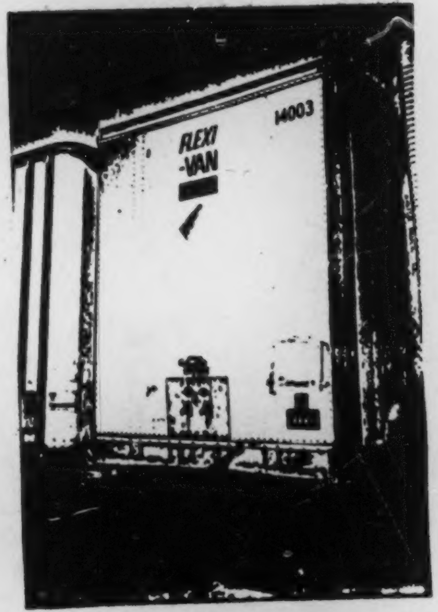
5. FRONT CONSTRUCTION

TO WITHSTAND THE HEAVY CARGO IMPACT, THE FRONT CONSTRUCTION OF A RAILROAD PIGGYBACK IS USUALLY CONSTRUCTED OF 6 HEAVY DUTY VERTICAL POSTS (OUTLINED IN THE PHOTO BY RIVET HEADS) AND AN INTERIOR LINING (NOT SHOWN) OF 3/4" PLYWOOD. ALSO A METAL MANIFEST (DOCUMENT) HOLDER MUST BE PROVIDED.

RAILROAD PIGGYBACK


Transamerica
Transportation Services
REAZ 231593

OTR TRAILER

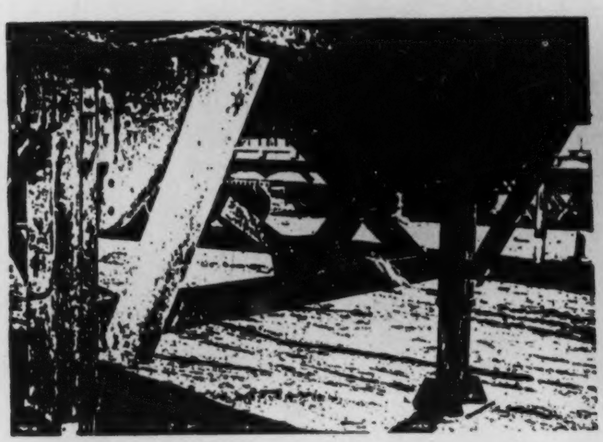

FLEXI-VAN
14003

FOUR POSTS,
1/4" INTERIOR PLYWOOD LINING,
NO MANIFEST HOLDER

7. LANDING GEAR

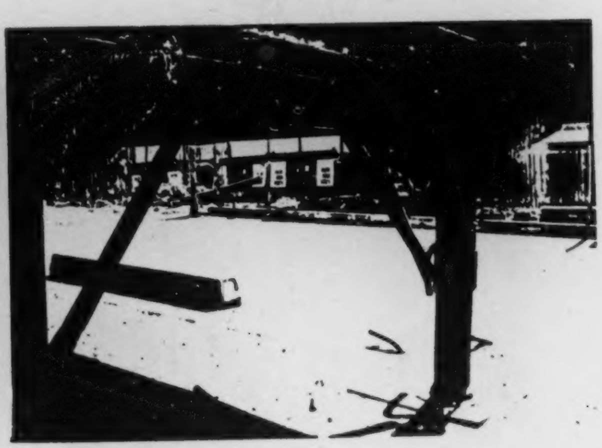
RAILROAD PIGGYBACKS REQUIRE HEAVY DUTY LANDING GEAR TO SUPPORT THE TRAILER AS IT IS UNLOADED FROM THE RAIL CAR AND SET DOWN ON THE GROUND BY THE PIGGYPACKER OR CRANE.

RAILROAD PIGGYBACK

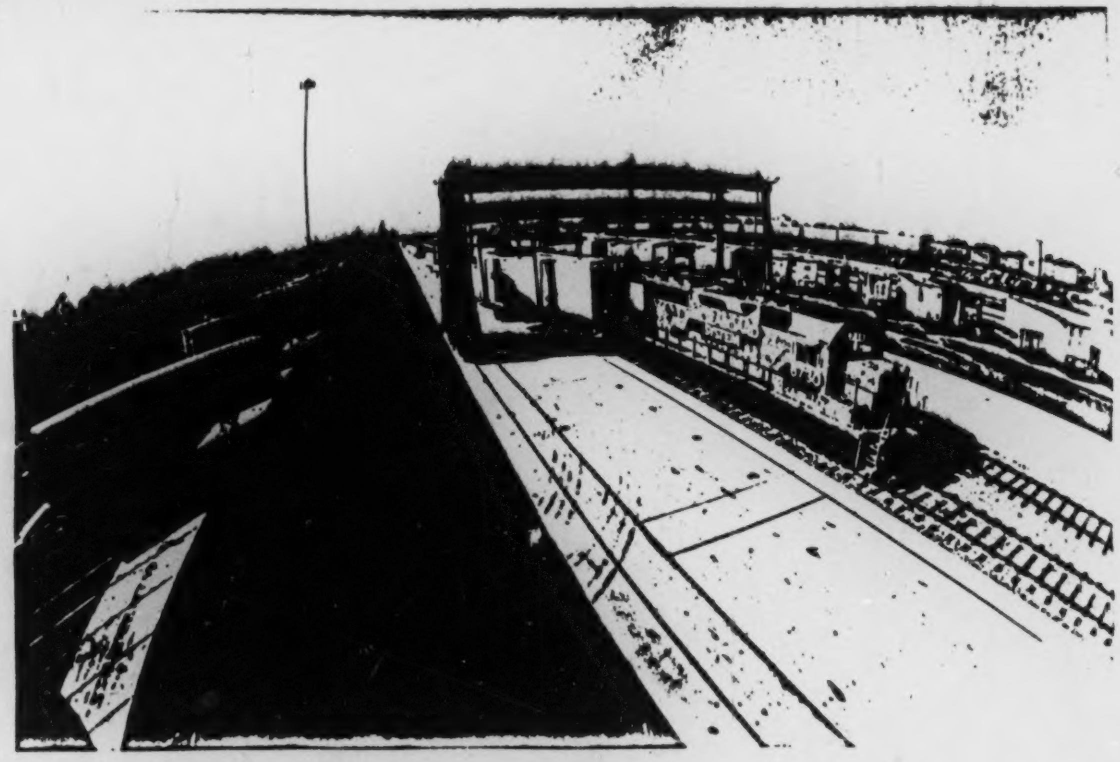


HEAVY DUTY SUPPORT MEMBERS
(WITH BRACING FORE, AFT, CROSS
AND DIAGONAL TO MEET AAR
TEST REQUIREMENTS)

OTR TRAILER



LIGHT DUTY SUPPORT MEMBERS



PAGE 9 RAILROAD PIGGYBACKS BEING LOADED ONTO FLAT CARS

ATTACHMENT B

COMMENTS AND LEGISLATIVE RECOMMENDATIONS CONCERNING APPROPRIATE APPLICATION AND LEVEL FOR RAILROAD PIGGYBACK EQUIPMENT
of
FEDERAL EXCISE TAX IMPOSED BY
INTERNAL REVENUE CODE SECTION 4051
on
FIRST RETAIL SALE OF HEAVY TRUCKS AND TRAILERS

Submitted

On behalf

of

an ad hoc group

of

Suppliers and Railroad Users of Piggyback Equipment
including
Santa Fe Southern Pacific Corporation
Atchison, Topeka, Santa Fe Railroad Company
Transamerica Interway Inc.
BRAE Corporation

Counsel:

Dale W. Wickham
Allen K. Halperin

PIPER & MARBURY
888 16th Street, N.W.
Washington, D.C. 20006
(202) 785-8150

Edward D. Heffernan
1513 16th Street, N.W.
Washington, D. C. 20036
(202) 797-7500

May 10, 1985

COMMENTS AND LEGISLATIVE RECOMMENDATIONS CONCERNING APPROPRIATE APPLICATION AND LEVEL FOR RAILROAD PIGGYBACK EQUIPMENT OF FEDERAL EXCISE TAX ON FIRST RETAIL SALE OF HEAVY TRUCKS AND TRAILERS

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May 10, 1985

COMMENTS AND LEGISLATIVE RECOMMENDATIONS CONCERNING APPROPRIATE APPLICATION AND LEVEL FOR RAILROAD PIGGYBACK EQUIPMENT OF FEDERAL EXCISE TAX ON FIRST RETAIL SALE OF HEAVY TRUCKS AND TRAILERS

This paper examines the policy considerations relating to the excise tax imposed on the first retail sale of heavy trucks and trailers by section 4051 of the Internal Revenue Code of 1954, and the relationship of that policy to the appropriateness of an exemption or lower rate of tax for railroad piggyback equipment.

This paper concludes with legislative recommendations as follows:

(1) to appropriately reflect the low percentage of highway use by railroad piggybacks, a reduced rate of tax for railroad piggybacks should be continued at a rate reduced to not more than 3% for sales on and after July 18, 1985, and

(2) a technical legislative correction (effective as to sales on and after July 18, 1984) is necessary to carry out Congressional intent to provide a rate reduction instead of a mere deferral of the tax for railroad piggybacks.

I. DISCUSSION

(a) Brief Legislative History of, and Policy Behind, Enactment of This Federal Excise Tax (Code section 4051)

Section 4051 of the Internal Revenue Code was enacted as part of the Highway Revenue Act of 1982. (See Appendix A for copy of section 4051 as amended to date.) The Act converted the prior law 10% manufacturers' excise tax on trucks to a 12% retail tax on heavy trucks and trailers, effective April 1, 1983. The prior tax applied to truck chassis and bodies weighing more than 10,000 pounds. The new retail tax imposed by section 4051 applies only to trucks weighing more than 33,000 pounds and trailers weighing more than 26,000 pounds.

The rationale for the change is clear: heavy trucks and trailers which make extensive use of the Nation's highways cause considerably greater damage to the highways than lighter vehicles or vehicles used primarily in non-highway functions, and therefore should pay more tax for maintenance of the highways. This policy is enunciated in the House Ways and Means Committee Report accompanying the Bill that was ultimately enacted as the Highway Revenue Act of 1982. The report states:

> "In light of testimony presented before the committee to the effect that the costs of future highway improvements would be unfairly distributed if the current manufacturers excise tax on trucks were not modified, the committee believes that this tax should be restructured to yield no tax or a lower tax for lighter vehicles and a higher tax for heavier vehicles. H. Rept. No. 97-945, 97th Cong., 2d Sess., p.14.

Consistent with the Congressional purpose of restructuring and shifting the burden of the retail excise tax to the heaviest and most extensive highway users, not only was the weight threshold for imposition of the tax significantly increased; Congress also exempted many articles that are suitable for highway use but which are in fact primarily designed for use and primarily used in nonhighway functions. Included in the list of exempt articles are rail vans. Notwithstanding that rail vans exceed the 26,000 pound weight threshold, are suitable for limited highway use and in fact are used to a limited extent on the highway, they were nevertheless exempted from the tax because they are used primarily on rail rather than on the road.

The Congressional policy and focus which led to restructuring of the tax in question in 1982 is straightforward. Vehicles which cause extensive damage to the highways because of the combination of their heavy weight and extensive use should bear the burden of the retail excise tax imposed by Code section 4051. Those articles which do not inflict such level of damage on the highways, either because of their lighter weight or because they are used primarily in a non-highway function, should not be subject to the tax.

As part of the Tax Reform Act of 1984, Congress enacted a temporary reduction (from 12% to 6%) in the rate of tax imposed on the first retail sale of railroad piggybacks during the 1-year period beginning July 18, 1984, with direction for a study to be conducted by the Department of Transportation (in consultation with the Treasury Department) as to the appropriate application and level of the tax on railroad piggybacks. A report on the study, with recommendations, is to be submitted to Congress by May 1, 1985. (See Appendix B for copy of the statutory provision (section 936 of the 1984 Tax Reform Act) directing this study.) This rate reduction applies to a trailer or semitrailer "designed for use principally in connection with trailer-on-flatcar ["TOFC"] service by rail," but only if the seller and purchaser are properly registered and then only if the purchaser certifies to the seller, at the time and in the manner required by Treasury Regulations, that the trailer or semitrailer "will be used principally" in TOFC service. The certificate required by the Regulation makes clear that a false certification, in addition to other sanctions, subjects the signer to criminal penalties. Thus, the required certificate provides immediately above the signature that --

> "I understand that the willful use of this certificate to evade or defeat the excise tax otherwise applicable under section 4051(a), will subject me to a fine of not more than $10,000 or imprisonment of not more than 5 years, or both, together with cost of prosecution."

(b) Designed and Actual Use of Railroad Piggybacks

In accordance with the underlying policy of the restructuring of the tax in 1982, the proper application and level of the tax to be imposed on railroad piggybacks should be determined primarily, if not exclusively, by focusing on the designed use and actual use of railroad piggybacks.

Railroad piggybacks are used to enable freight to be moved long distances by rail on flatcars rather than in boxcars. The principal users of railroad piggybacks are railroads. Use of railroad piggybacks enable railroads to move freight more efficiently by decreasing handling requirements that would otherwise be necessary in loading and unloading boxcars. Highway use of railroad piggybacks is typically limited to relatively short-distance pick up and delivery between the origination or destination point and the rail terminal. The function and use of a railroad piggyback is to transport freight for long distances by rail and for short distances between the railroad terminal and the point of local origination or destination. Railroad piggybacks spend most of their time and miles in the transportation of freight by rail and not on the Nation's highways. A random survey of Nationwide railroad piggyback highway use on the basis of hubodometer readings, conducted by the Nation's largest owner of railroad piggybacks in the fall of 1984 (after enactment of the current 6% rate reduction for piggybacks), shows an average annual highway use of less than 4,000 miles.

Because railroad piggybacks are used primarily off the highway on rail, it is necessary that railroad piggybacks contain special features and construction that would be inappropriate for a trailer intended to be used primarily on the highways. These special features are required by the

Association of American Railroads ("AAR") before railroad piggybacks can be certified as such. The special features include lift pads, a stanchion plate, extra heavy-duty locking bars, extra door thickness, extra heavy-duty construction with recessed fittings, heavy-duty side posts, heavy-duty support members, and special suspension assembly. These special features and components result in a railroad piggyback being more than 1,000 pounds heavier and over $900 more costly than an over-the-road trailer. (An ordinary over-the-road trailer is estimated to have a taxable cost of about $10,600.)[*]

(c) Relevant and Irrelevant Criteria for Determining Appropriate Level of Tax on Railroad Piggybacks.

Considering the Congressional purpose in imposing the retail excise tax on the sale of heavy trucks and trailers, there should be but one primary criterion in determining the appropriate application and level of tax for railroad piggybacks. That should be the percentage of their average highway use ("Highway Use Percentage").

The Highway Use Percentage for railroad piggyback equipment could appropriately be determined under one of several possible methods, each of which would produce a fraction or percentage that should be applied to the full 12% rate of tax to find the maximum reduced rate of tax appropriately applicable to railroad piggyback equipment. One method would state Nationwide average annual mileage of highway usage by railroad piggyback equipment as a percentage of Nationwide average annual mileage of highway usage by heavy (i.e., taxable) over-the-road trailers; a second method would state Nationwide average annual mileage of highway usage by railroad piggyback equipment as a percentage of Nationwide average annual mileage of both the highway and off-highway uses of that equipment; and so on.

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[*] The facts and figures contained herein were supplied by various participants in the ad hoc group of suppliers and railroad users of piggyback equipment on behalf of whom this paper is submitted.

Only average numbers reflecting equipment usage conditions Nationwide should be employed under any of the methods for determining reduced rate of tax to be applied Nationwide to railroad piggyback equipment. Proper methodology clearly ought not employ aberrations from annual Nationwide averages as substitutes for appropriately comprenhensive averages of aggregate usage.

Whatever method is used, evidence before the Department of Transportation shows that the Highway Use Percentage for railroad piggyback equipment is quite small, justifying a reduction in the rate for railroad piggyback equipment to a point that ranges from zero to a maximum of 3%.

As previously stated, the recent random survey referred to above shows average annual highway use of railroad piggybacks to be less than 4,000 miles. The average annual highway mileage of heavy over-the-road trailers has been estimated to range from 32,000 miles to 68,000 miles. It is believed that the lower number (32,000 miles) may include many light over-the-road trailers that are not subject to the tax imposed by section 4051 by reason of having a gross vehicle weight below the 26,000 pound threshold. It is further believed that the average annual highway mileage for over-the-road trailers comparable in size and weight to railroad piggyback equipment is in the range of 50,000 to 68,000 miles.

Under the first method (average annual piggyback highway mileage/average annual over-the-road trailer highway mileage), the Highway Use Percentage resulting under the least favorable ratio stated above (4,000/32,000) would be 12.5%, and under the most favorable (4,000/68,000) would be 5.9%. Application of those ratios to the prevailing 12% rate of excise tax on a fully taxable sale produces a maximum appropriate reduced rate of tax for railroad piggyback sales ranging from a high of 1.5% to a low of about 7/10 of 1%.

As to the second method (average annual piggyback highway mileage/average annual piggyback total mileage), Transamerica Interway Inc. in cooperation with Trailer Train Company has prepared an estimate of average annual rail mileage of railroad piggyback equipment. Based upon data for calendar year 1984 supplied by Trailer Train Company, which owns most of the flatcars used by railroads in intermodal transportation, it is estimated that average annual rail mileage of railroad piggyback equipment is approximately 36,000 miles. This is believed to be a conservative estimate. Based upon average annual highway mileage of railroad piggyback equipment of 4,000 miles, the Highway Use Percentage under this formulation is 10% (4,000/40,000). Application of this percentage to the prevailing 12% tax rate produces an appropriate reduced rate of tax of 1.2% for sales of railroad piggyback equipment.

A railroad locomotive, boxcar or other rolling stock is not, and obviously should not be, subject to this retail excise tax. The simple reason is that such equipment does not use the highways. The same is true as to railroad piggybacks. Railroad piggybacks generally are not used over the highways; they are used primarily off the highways in rail (and sometimes in over-the-water) service. They are more akin to boxcars or rail vans or other railroad rolling stock than to over-the-road trailers. They should either be wholly exempt from the tax or subject to the tax at a significantly lower rate.

Nevertheless, in view of some of the extraneous and irrelevant issues that have been raised in the past with respect to the appropriate application and level of the tax to railroad piggybacks, a reemphasis of the obvious is perhaps appropriate. For example, opponents of an exemption or rate reduction for railroad piggybacks have suggested that such an exemption or rate reduction constitutes a subsidy to railroad piggyback users at the expense of heavy truckers. It is submitted that this is the exact opposite of what is true. If the rate of tax on railroad piggybacks were allowed to revert to 12%, or even were permitted to continue at the existing 6% rate, such rates of tax would greatly exceed the rate that would be appropriate to the Highway Use Percentage for piggybacks. With a full 12% or even a partial 6% rate on railroad piggybacks, there truly would be a "hidden subsidy" benefiting heavy highway users at the expense of railroad and other off-highway users. Obviously, if aircraft, ships, and railroad locomotives and boxcars were subjected to the retail excise tax imposed by section 4051, highway users would have to pay less tax with respect to their heavy trucks. Yet, no one would seriously suggest that the failure to impose the tax on such items represents a subsidy to the airlines, shipping companies and railroads at the expense of the highway truck users. Railroad piggybacks are used primarily as an alternative to boxcars. A railroad piggyback is primarily designed for use, and is in fact primarily used, for off-highway service -- on rail (or over water to a lesser extent) -- not for service on highways. It is therefore incongruous to assert that a rate reduction for railroad piggybacks which is consistent with their design use, and actual use, primarily off-highway on rail constitutes a subsidy to the railroads.

Another argument has been raised by opponents of an exemption or rate reduction for railroad piggybacks. That is that the effect of an exemption or rate reduction, to the extent that the tax savings would exceed the additional cost of a railroad piggyback over the cost of an over-the-road trailer, could lead to potential tax abuse, whereby an over-the-road trucker would purchase a railroad piggyback merely to avoid the tax. Existing evidence clearly indicates that the existing 6% rate reduction has not led to such abuse. Of course, in the case of a 6% rate reduction, the tax savings does not exceed the additional cost of equipping a railroad piggyback trailer to AAR specifications. Obviously, since there has never been a total exemption for railroad piggybacks, one cannot know with certainty whether a Nationwide change in the pattern of highway use by railroad piggybacks might occur in the future if there were a complete exemption for them. The better view is that an over-the-road user would not logically add 1000 pounds of weight to his truck (and in the process commit a criminal offense by falsely certifying as to non-highway use of the trailer) merely to create a savings of a few hundred dollars.

II. LEGISLATION RECOMMENDED

(a) Permanent Reduction of Rate for Railroad Piggybacks to Not More than 3% for Sales on and after July 18, 1985.

It is recommended that section 4051(d)(1) of the Internal Revenue Code be amended to make permanent the temporary, 1-year rate reduction for railroad piggybacks (which is currently scheduled to expire as to sales after July 17, 1985). It is further recommended that the rate of tax for railroad piggybacks be set at not more than 3% for sales after July 17, 1985, until the expiration of the entire tax (which is scheduled to expire as to sales after September 30, 1988).

Railroad piggybacks are primarily designed for, and primarily used in, off-highway rail transportation. Railroad piggybacks are not used extensively in highway transportation. To the extent that railroad piggybacks do not use and damage the highways (in relation to the use and damage of highways by over-the-road trailers) railroad piggybacks should not be subject to special taxes to pay for maintenance of highways, just as over-the-road trailers should not be required to pay for maintenance of the Nation's rail system.

A strong case can be made for total exemption of railroad piggybacks from the tax imposed by Code section 4051, as is presently the case with rail vans and light trucks. Nevertheless, a complete exemption is not urged herein. Instead, it is recommended that the rate of tax be set at a level that reflects the limited percentage of highway use by railroad piggybacks.

If there really is a serious concern that the future might bring Nationwide changes in the patterns for use of transportation equipment involving a substantial increase in the Highway Use Percentage for railroad piggyback equipment, there are mechanisms that would readily meet such fears. One such mechanism would be for the Congress to authorize the Treasury Department, on prescribed terms and conditions, to promulgate regulations making a prospective increase in the reduced rate of tax for railroad piggybacks. The prescribed terms and conditions would permit the Treasury to exercise its authority to increase the rate of tax only to the extent the rate increase was substantiated by the previously promulgated results of a periodic review required to be made every 3 years by the Department of Transportation to determine any significant increases in the Nationwide Highway Use Percentage for railroad piggybacks. Such a prospective increase in the rate of tax for railroad piggybacks should not be allowed to exceed one percentage point for each 10% increase Nationwide in the Highway Use Percentage for railroad piggybacks. Thus, if the present federal excise tax on heavy trucks and trailers were to be extended beyond its presently scheduled date of expiration as to sales of equipment made after September 30, 1988, the rate of reduced tax on railroad piggyback equipment might be increased by one percentage point in the case of equipment sold after September 30, 1989, if 90 days or more before that date the Treasury promulgated a regulation to that effect, and if before promulgation of such regulation there had been published in the Federal Register the required finding

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by the Department of Transportation, made (after public notice and hearing), that the Highway Use Percentage for railroad piggyback equipment during the 3 years ending September 30, 1988, showed at least a 10% increase Nationwide over the Highway Use Percentage for such equipment in the prior 3-year period.

(b) Technical Amendments to Effectuate Intended Tax Rate Reduction Instead of Mere Defferal of Tax for Railroad Piggybacks

It is recommended that there be enacted, effective as to railroad piggyback sales on and after July 18, 1984, the technical amendments to Code section 4051(d)(3) needed to cause the Congressionally intended rate reduction for railroad piggybacks to operate as such and not merely as a tax deferral. This preferably should be accomplished by retroactively repealing the additional tax imposed by section 4051(d)(3) as a result of any railroad piggyback's change in qualifying use (whether by resale or otherwise), occuring after the first retail sale. Alternatively, this could be done by retroactively imposing on the additional tax on non-qualifying use the below described pair of limits on both the time for its application and its amount.

Paragraph (3) of Code section 4051(d) defeats the Congressionally intended rate reduction for railroad piggybacks by imposing an additional tax of 6% of the original purchase price of a railroad piggyback if it is at any time used or resold for use other than principally in TOFC service. There is absolutely no time limitation within which such use conversion may occur for the additional tax to be triggered. Railroad piggybacks will eventually be scrapped or resold for use other than principally in TOFC service (e.g., storage, local transportation, etc.), but typically not until they have been used for many years in TOFC service. Thus, section 4051(d) as presently drafted erroneously converts what was intended to be a tax reduction into a tax deferral.

1. Repeal the provision in paragraph (3) of Code section 4051(d) imposing an additional tax on use conversion. The additional tax imposed by paragraph (3) on a change in the equipment's use after the original taxable sale is not necessary, and is, in fact, punitive when compared to other excise tax exemptions or rate reductions. Thus, the seven other categories of equipment exempted from this tax under the provisions of Code section 4053 make the availability of the exemption depend on the designed use of the equipment as of the time of the taxable sale -- without even requiring a certificate of such designed use to be executed under criminal penalties. This has the desirable effect of eliminating the problems of enforcement for the IRS and of compliance by taxpayers that result from causing a determination that must be made at the time of the sale to be changed later on by reason of facts as to actual use after the sale. The criminal and

--

other sanctions imposed for falsification by a purchaser of the unusual certificate required as to the intended use of a railroad piggyback should be sufficient additional protection, without adding the administrative and compliance costs and burdens associated with continuous after-sale monitoring and tax reporting on uses of equipment.

2. If the additional tax were nevertheless retained, a pair of limits on both the time for its application and its amount should be imposed to help correct the error.

(a) Imposition of time limit for application of additional tax under paragraph (3). -- There clearly should be no additional tax if a railroad piggyback is used principally in TOFC service or other non-highway use for a significant period, which could be from 6 months to 2 years. This change in the statute can be accomplished by amending the first clause of paragraph (3) of Code section 4051(d), inserting immediately after "paragraph (2)" the following: "within [insert a period not less than 6 months nor more than 2 years] of the date such trailer or semitrailer is placed in service."

(b) Limitation on amount of additional tax. -- The amount of any additional tax should be limited so that such additional tax, when considered together with the tax previously paid on the railroad piggyback, will not exceed 12% of its resale or fair market value at the time of the change to a disqualifying use. Such a change would achieve the proper result of limiting the imposition of the full rate of tax only to the value of the equipment at the time of its conversion to the highway uses appropriately covered by the tax.

This limitation can be accomplished by amending subparagraph (B) of paragraph (3) of section 4051(d) to read as follows:

> "(B) the amount of the tax imposed under subsection (a) on such sale shall be equal to 12% of the amount for which the trailer is so resold (or in the case of a trailer which is not so resold but which is used for a use other than a use described in paragraph (2), 12% of the fair market value of the trailer determined at the time of such change in use), reduced (but not below zero) by the amount of tax previously imposed under subsection (a) with respect to such trailer."

Effective date. -- To effectuate the Congressionally intended rate reduction, the corrective technical amendment should be made effective as if included in the railroad piggyback rate reduction provision upon its original enactment, so that the provision as amended applies to any sale of a railroad piggyback made after July 17, 1984.

* * *

APPENDIX A

Subchapter B—Heavy Trucks and Trailers

Sec. 4051. Imposition of tax on heavy trucks and trailers sold at retail.
Sec. 4052. Definitions and special rules.
Sec. 4053. Exemptions.

SEC. 4051. IMPOSITION OF TAX ON HEAVY TRUCKS AND TRAILERS SOLD AT RETAIL.

(a) Imposition of Tax.—

(1) In general.—There is hereby imposed on the first retail sale of the following articles (including in each case parts or accessories sold on or in connection therewith or with the sale thereof) a tax of 12 percent of the amount for which the article is so sold:

(A) Automobile truck chassis.

(B) Automobile truck bodies.

(C) Truck trailer and semitrailer chassis.

(D) Truck trailer and semitrailer bodies.

(E) Tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.

(2) Exclusion for trucks weighing 33,000 pounds or less.—The tax imposed by paragraph (1) shall not apply to automobile truck chassis and automobile truck bodies, suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less (as determined under regulations prescribed by the Secretary).

(3) Exclusion for trailers weighing 26,000 pounds or less.—The tax imposed by paragraph (1) shall not apply to truck trailer and semitrailer chassis and bodies, suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less (as determined under regulations prescribed by the Secretary).

(4) Sale of trucks, etc., treated as sale of chassis and body.—For purposes of this subsection, a sale of an automobile truck or truck trailer or semitrailer shall be considered to be a sale of a chassis and of a body described in paragraph (1).

(b) Separate Purchase of Truck or Trailer and Parts and Accessories Therefor.—Under regulations prescribed by the Secretary—

(1) In general.—If—

(A) the owner, lessee, or operator of any vehicle which contains an article taxable under subsection (a) installs (or causes to be installed) any part or accessory on such vehicle, and

(B) such installation is not later than the date 6 months after the date such vehicle (as it contains such article) was first placed in service,

then there is hereby imposed on such installation a tax equal to 12 percent of the price of such part or accessory and its installation.

(2) Exceptions.—Paragraph (1) shall not apply if—

(A) the part or accessory installed is a replacement part or accessory, or

(B) the aggregate price of the parts and accessories (and their installation) described in paragraph (1) with respect to any vehicle does not exceed $200 (or such other amount or amounts as the Secretary may by regulations prescribe).

(3) Installers secondarily liable for tax.—The owners of the trade or business installing the parts or accessories shall be secondarily liable for the tax imposed by paragraph (1).

(c) Termination.—On and after October 1, 1988, the taxes imposed by this section shall not apply.

(d) TEMPORARY REDUCTION IN TAX ON CERTAIN PIGGYBACK TRAILERS.—

(1) IN GENERAL.—In the case of piggyback trailers or semitrailers sold within the 1-year period beginning on the date of the enactment of the Tax Reform Act of 1984, subsection (a) shall be applied by substituting "6 percent" for "12 percent".

(2) PIGGYBACK TRAILERS OR SEMITRAILERS.—For purposes of this subsection, the term "piggyback trailers or semitrailers" means any trailer or semitrailer—

(A) which is designed for use principally in connection with trailer-on-flatcar service by rail, and

(B)(i) both the seller and the purchaser of which are registered in a manner similar to registration under section 4222, and

(ii) with respect to which the purchaser certifies (at such time and in such form and manner as the Secretary prescribes by regulations) to the seller that such trailer or semitrailer—

(I) will be used, or resold for use, principally in connection with such service, or

(II) will be incorporated into an article which will be so used or resold.

(3) ADDITIONAL TAX WHERE NONQUALIFIED USE.—If any piggyback trailer or semitrailer was subject to tax under subsection (a) at the 6 percent rate and such trailer or semitrailer is used or resold for use other than for a use described in paragraph (2)—

(A) such use or resale shall be treated as a sale to which subsection (a) applies,

(B) the amount of the tax imposed under subsection (a) on such sale shall be equal to the amount of the tax which was imposed on the first retail sale, and

(C) the person so using or reselling such trailer or semitrailer shall be liable for the tax imposed by subsection (a).

(e) TRANSITIONAL RULE.—In the case of any article taxable under subsection (a) on which tax was imposed under section 4061(a), subsection (a) shall be applied by substituting "2 percent" for "12 percent".

Source: New.

SEC. 4052. DEFINITIONS AND SPECIAL RULES.

(a) FIRST RETAIL SALE.—For purposes of this subchapter—

(1) IN GENERAL.—The term "first retail sale" means the first sale, for a purpose other than for resale, after manufacture, production, or importation.

(2) LEASES CONSIDERED AS SALES.—Rules similar to the rules of section 4217 shall apply.

(3) USE TREATED AS SALE.—

(A) IN GENERAL.—If any person uses an article taxable under section 4051 before the first retail sale of such article, then such person shall be liable for tax under section 4051 in the same manner as if such article were sold at retail by him.

(B) EXEMPTION FOR USE IN FURTHER MANUFACTURE.—Subparagraph (A) shall not apply to use of an article as material in the manufacture or production of, or as a component part of, another article to be manufactured or produced by him.

(C) COMPUTATION OF TAX.—In the case of any person made liable for tax by subparagraph (A), the tax shall be computed on the price at which similar articles are sold at retail in the ordinary course of trade, as determined by the Secretary.

(b) DETERMINATION OF PRICE.—

(1) IN GENERAL.—In determining price for purposes of this subchapter—

(A) there shall be included any charge incident to placing the article in condition ready for use,

(B) there shall be excluded—

(i) the amount of the tax imposed by this subchapter,

(ii) if stated as a separate charge, the amount of any retail sales tax imposed by any State or political subdivision thereof or the District of Columbia, whether the liability for such tax is imposed on the vendor or vendee,

(iii) the fair market value (including any tax imposed by section 4071) at retail of any tires (not including any metal rim or rim base), and

(iv) the value of any component of such article if—

(I) such component is furnished by the first user of such article, and

(II) such component has been used before such furnishing, and

(C) the price shall be determined without regard to any trade-in.

(2) SALES NOT AT ARM'S LENGTH.—In the case of any article sold (otherwise than through an arm's-length transaction) at less than the fair market price, the tax under this subchapter shall

SEC. 4053. EXEMPTIONS.

No tax shall be imposed by section 4051 on any of the following articles:

(1) CAMPER COACHES BODIES FOR SELF PROPELLED MOBILE HOMES.—Any article designed—

(A) to be mounted or placed on automobile trucks, automobile truck chassis, or automobile chassis, and

(B) to be used primarily as living quarters or camping accommodations.

(2) FEED, SEED, AND FERTILIZER EQUIPMENT.—Any body primarily designed—

(A) to process or prepare seed, feed, or fertilizer for use on farms,

(B) to haul feed, seed, or fertilizer to and on farms,

(C) to spread feed, seed, or fertilizer on farms,

(D) to load or unload feed, seed, or fertilizer on farms, or

(E) for any combination of the foregoing.

(3) HOUSE TRAILERS.—Any house trailer.

(4) AMBULANCES, HEARSES, ETC.—Any ambulance, hearse, or combination ambulance-hearse.

(5) CONCRETE MIXERS.—Any article designed—

(A) to be placed or mounted on an automobile truck chassis or truck trailer or semitrailer chassis, and

(B) to be used to process or prepare concrete.

(6) TRASH CONTAINERS, ETC.—Any box, container, receptacle, bin or other similar article—

(A) which is designed to be used as a trash container and is not designed for the transportation of freight other than trash, and

(B) which is not designed to be permanently mounted on or permanently affixed to an automobile truck chassis or body.

(7) RAIL TRAILERS AND RAIL VANS.—Any chassis or body of a trailer or semitrailer which is designed for use both as a highway vehicle and a railroad car. For purposes of the preceding sentence, piggy-back trailer or semitrailer shall not be treated as designed for use as a railroad car.

APPENDIX B

SEC. 931. STUDY OF PIGGYBACK TRAILERS.

(a) In General.—The Secretary of Transportation (in consultation with the Secretary of the Treasury) shall conduct a study of the appropriate application and level of the tax imposed by section 4051 of the Internal Revenue Code of 1954 (relating to tax on trucks and trailers sold at retail) on piggyback trailers and semi-trailers.

(b) Report.—Not later than May 1, 1985, the Secretary of Transportation shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under subsection (a) together with such recommendations as the Secretary may deem advisable.

APPENDIX C

SEC. 932. WEIGHT-DISTANCE TAXES.

The Secretary of Transportation shall conduct a study to evaluate the feasibility and ability of weight-distance truck taxes to provide the greatest degree of equity among highway users, to ease the costs of compliance of such taxes, and to improve the efficiency by which such taxes might be administered. Such study shall also include an evaluation of the evasion potential for weight-distance taxes and an assessment of the benefits to interstate commerce of replacing all Federal truck taxes (other than fuel taxes) with a weight-distance tax.

APPENDIX D

SEC. 934. REPORTS, ETC.

(a) Consultation With Treasury.—Studies conducted under this part shall be conducted in consultation with the Secretary of the Treasury.

(b) Report.—Not later than October 1, 1987, the Secretary of Transportation shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on each study conducted under this part together with such recommendations as the Secretary may deem advisable.

The **Chairman**. Senator Long?

Senator **Long**. No questions, Mr. Chairman.

The **Chairman**. Gentlemen, I have no questions. Let me say again to everyone here: I am going to try to hold this bill to genuine technical corrections. I do not want to revisit substantive decisions we have made, or we are going to be into a minitax reform bill when we have already got a major tax reform bill that is going to be before us. To the extent they were honest mistakes or technical errors, we will try to correct them. To the extent that they are substantive changes, I think the committee will be reluctant to undertake them. Thank you very much. We are adjourned.

[Whereupon, at 11:24 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

PAUL LAXALT
NEVADA

COMMITTEE ON APPROPRIATIONS
COMMITTEE ON JUDICIARY

United States Senate
WASHINGTON, DC 20510

WASHINGTON OFFICE
323A Russell Office Building
(202) 224-3542

CARSON CITY OFFICE
705 North Plaza Street
(702) 883-1930

LAS VEGAS OFFICE
300 Las Vegas Blvd., South
(702) 388-6547

RENO OFFICE
300 Booth Street
(702) 784-5588

TESTIMONY OF SENATOR
PAUL LAXALT
ON S. 814, TECHNICAL CORRECTIONS BILL,
BEFORE THE SENATE FINANCE COMMITTEE
JUNE 5, 1985

Paul Laxalt

Mr. Chairman:

White Pine County is an economically distressed County in Nevada. It became so when it lost its principal economic activity, copper mining and smelting. To alleviate this distress, the Nevada legislature in 1979 authorized the White Pine Power Project a 1500 megawatt coal fueled electric generation facility pursuant to Nevada's County Economic Development Revenue Bond law. The project will bring electric power to rural Nevada and to metropolitan regions of Nevada and California. It is to be financed by tax exempt revenue bonds.

The project will provide 2,600 direct and 554 support jobs to White Pine County during its four to six year construction phase and 530 direct and 212 support jobs during its 35 year post construction life (the County's population is barely 9,000). The project will also provide payments in lieu of tax to the State of Nevada and its counties of $448,000,000 in 1983 dollars over the project life.

The Technical Corrections Act of 1985 provides that the "grandfather" rule (Section 631 (c) (3) of the Tax Reform Act of 1984) will not apply to Section 103 (o) of the Internal Revenue Code. This legislation would cause the loss of the tax exempt feature of the bonds of the White Pine Power Project issued after July 18, 1984, because a "significant portion," i.e., 5% or more, of the bond proceeds could be deemed directly or indirectly "loan" to non-exempt persons (Nevada Power Company in southern Nevada and the Sierra Pacific Power Company and Mt. Wheeler Power in northern Nevada have reserved rights in the aggregate to purchase 25% of the capacity of the project). Project bond counsel advises me that they could not give an unqualified opinion that the project's financing arrangements would not constitute "indirect loans." Without tax exempt financings, the project more than likely will not go forward. Thus, denial of tax exempt financing to it will not produce any federal revenue.

This project has been in the planning stage since 1979 and in excess of $20,000,000 has been expended or committed for expenditures to finance the development and study costs associated with its ultimate construction. These funds have been used or committed to conduct extensive feasibility and environmental impact studies to determine the feasibility of the project itself, satisfy the mandate of the National Environmental Protection Act and obtain the water, air quality and right-of-way permits required for the project. All this was done in conformity with and good faith reliance upon existing federal laws.

Should the Committee proceed to act on the proposed change as a "technical" amendment, I urge that this project be given "grandfather" status, that is, that its obligations not be treated as private loan bonds and not be made subject to Section 103 (o) of the Internal Revenue Code. I think fairness requires this. In light of the reliance of the project on the grandfather provision of the Tax Reform Act and the fact that the Technical Corrections Act makes substantive changes in the Tax Code, I question whether Section 169 of the bill qualifies as a simple "technical" amendment. Its impact will be substantial on the project and obviously has far reaching policy implications which should be the subject of full public and Committee review.

Thank you for your consideration of this request.

For June 5, 1985 Hearing on Technical Corrections

RECOMMENDED IMPROVEMENTS IN DEFRA AND REA TECHNICAL CORRECTIONS BILLS

SUBMITTED BY THE
AMERICAN SOCIETY OF PENSION ACTUARIES
MAY 28, 1985

(The American Society of Pension Actuaries is a national professional society whose 2,000 members provide actuarial, consulting and administrative services to approximately 30% of the qualified retirement plans in the United States.)

A) SUGGESTED MODIFICATIONS OF DEFRA CORRECTIONS

1) The Pre-59½ Distribution Penalty Transition Provisions

Under the proposed bill, amounts attributable to contributions paid before January 1, 1985 are exempted from the penalty. The exemption should be changed so that it applies to amounts accrued before January 1, 1985. In the case of a defined contribution plan, this would include amounts actually credited as well as amounts with respect to which the employer's obligation to make the credit had become fixed. It would also apply to later adjustments for investment changes on these January 1, 1985 balances. Without these changes, the bill presents two administrative problems.

a) Respecting defined contribution plans, it will be necessary to track forfeitures reallocated after January 1, 1985 and determine whether they are attributable to contributions made before that date.

b) Respecting defined benefit plans, it is not clear what accruals are attributable to what contributions.

Our suggested modifications overcome both problems.

2) The 70½ Distribution Requirement for 5% Owners

The bill should provide clarification on these points:

a) Is the 5% owner who reached 70½ long before DEFRA subject to the special distribution requirement?

b) Consider the individual who is not a 5% owner at age 70½ but becomes one later. Is he subject to the requirement, and if so, when?

c) Relative to effective dates, it should be made clear whether the first key April 1st is April 1, 1985, or April 1, 1986.

3) Definition of a Welfare Fund

The proposed bill attempts to provide "clarification" regarding circumstances in which an insurance company arrangement constitutes a welfare fund. The proposals do not reflect current practices regarding retentions and experience rating. Under these practices, the contract itself does not provide a guaranteed experience rating formula. However, the extra-contractual arrangement between the insurer and the contractholder always assures that a formula will be followed. This distinction between form and practice should be recognized. The original intent of DEFRA will probably be best served if the proposed "clarification" is deleted.

B) DEFRA CORRECTIONS WHICH SHOULD NOT BE MADE

1) Repeal of IRC §2517

This proposal is substantive and does not appear to constitute an appropriate subject for a "technical corrections act." The proposed repeal would impact any irrevocable participant election of an annuity form which provides death benefits payable to a non-spouse. This tax treatment would apply at the time the election becomes irrevocable. This would be the case, for example, if a joint and survivor annuity were elected naming a non-spousal joint annuitant. §2517 probably should not be repealed even as part of a substantive tax act. What should be included is an amendment to §2517 exempting the employee's spouse as well as the employee. Without this amendment, there will be a gift whenever the spouse consents to an election away from spousal protection under §417.

2) Amendment of IRC §401(h)

The proposed change extending new restrictions to all key employees and not just 5% owners is also substantive and inappropriate for a "technical corrections act." There is no indication that DEFRA was unclear on the application of the new restriction. There is no indication that statutory language was in any way at odds with Congressional intent. It is not appropriate to justify the proposed change on the basis of bringing §401(h) into line with new welfare fund rules. The difference between the two sets of rules goes beyond the question of which employees are subject to the new separate account requirement. For example, the two sets of rules are different on the issue of unrelated business taxable income. They are different, as well, on the issue of reversion upon plan termination. Finally, they are different on the question of anticipating inflation.

C) SUGGESTED MODIFICATIONS OF REA CORRECTIONS

1) Status of Defined Contribution Qualified Pre-Retirement Benefits

There should be an acknowledgement that qualified pre-retirement death benefits in defined contribution plans are fully subsidized whenever account balances are not forfeited upon death. It should also be acknowledged that §417 currently has some shortcomings in failing to deal with this particular type of fully subsidized death benefit. These rules should be considered for this fully subsidized benefit:

a) The prohibition against opting out before age 35 does not apply.

b) The requirements for notice and consent do apply. The notice requirement should provide for notice "within a reasonable period after the individual becomes a participant."

2) The Requirement to Use PBGC-Acceptable Interest Rates

This issue involves the rules on involuntary settlement of an amount whose value does not exceed $3,500. The rule respecting PBGC-acceptable interest rates should only apply to determining whether a benefit is eligible for involuntary lump sum settlement. It should not apply to determining how much the settlement should be. Determinations relative to the amount of settlement should continue to be subject to the plan's basis of actuarial equivalence. To extend the PBGC-acceptable rate to determination of the amount will lead to discontinuities between lump sum settlements and other forms of settlements. These discontinuities will lead to such bizarre settlement forms as installments for two years certain.

If it is felt desirable to regulate plan definitions of actuarial equivalence more closely than at present, new rules should be carefully worked out and should be applied to all forms of settlement.

3) Amounts to Which the $3,500 Test Applies

There is confusion regarding the amounts to be taken into consideration in applying the $3,500 test.

These rules should be considered:

a) The test is made after subtracting any non-vested amounts.

b) Amounts subject to the test include mandatory employee contribution account balances.

c) Amounts exclude voluntary employee contribution account balances.

4) Treatment of Lump Sum Settlements and In-Service Distributions for Spousal Consent Purposes

There is a good deal of uncertainty within the retirement plan community over whether lump sum settlements and in-service distributions are subject to spousal consent rules. This uncertainty should be eliminated either by statutory correction or by regulation. It seems clear that both transactions must be subject to spousal consent rules - assuming the profit-sharing exemption is inapplicable.

5) Restrictions on Deferred Annuities for Terminated Employees

Vested terminators from defined benefit plans which do not subsidize the pre-retirement spousal benefit represent very difficult administrative problems. In this and the next item, we are suggesting two avenues to elimination of these problems.

Under one avenue, a plan sponsor would be permitted to force the employee into a deferred annuity which includes a pre-retirement death benefit regardless of the former employee's marital status. The death benefit would ordinarily be the termination-time lump sum value of the deferred annuity plus interest to date of death. If the normal form of benefit did not include such a pre-retirement benefit, the terminating employee would find himself forced into a deferred annuity with a lower monthly payment than would have been the case under the normal form.

By providing that there is always a pre-annuity-commencement-date death benefit, the plan administrator sidesteps a difficult fact-finding problem. The problem is to determine, at the former employee's annuity commencement date, how much of the time between employment termination and the annuity commencement date the former employee had been married.

The point to be clarified in the technical corrections bill is that restricting vested terminators to deferred annuities which always include pre-retirement death benefits is not a cut-back. Before REA, the plan probably did not incorporate any such restriction.

6) Locking in the Vested Terminating Employee's Election at Time of Termination

In the preceding section, we suggested one method of avoiding a potentially difficult administrative problem relative to vested terminators.

A second method would be to freeze the employee's status at time of employment termination. If the employee made an election with spousal consent at time of employment termination, the spousal consent would never again be required, for any later change in election. This rule would apply whether or not the employee is married to the same spouse at time of annuity commencement. The employee who is single at time of employment termination would not be subject to spousal rules at any time thereafter. The employee who, at time of termination, is married and unable to obtain spousal consent would be forever locked into an annuity containing the pre-retirement death benefit. Furthermore, that death benefit would be related to the survivorship of the individual to whom the participant had been married at the time of termination.

7) Treatment of Non-Deductible Employee Contribution Account Balances

The proposed bill should be revised to clarify treatment of non-deductible employee contribution account balances relative to qualified pre-retirement death benefit provisions. Treatment appears clear in defined contribution plans: 50% of the account is subject to pre-retirement spousal benefit rules. Treatment is unclear in defined benefit plans.

One option is to apply defined contribution rules to the employee contribution account balance. There is an analogue for this approach in the application of §415 provisions.

The other option is to convert the account balance to an accrued benefit of the same form as the employer-financed accrued benefit. Then, the employee-financed accrued benefit would be added to the employer-financed benefit. Defined benefit spousal rules would be applied to the total.

This second option leads to differences in treatment of employee contribution account balances depending on the type of plan (defined benefit or defined contribution) of which they are part. The first option appears preferable.

8) Treatment of Employee Deductible Contribution Balances

The bill should clarify treatment of deductible employee contribution account balances relative to spousal annuity provisions. At present, these accounts appear subject to all spousal annuity rules. However, policy in the past has been to maintain consistency between treatment of these accounts and treatment of IRA account balances. Accordingly, we believe failure to exempt deductible employee contribution account balances from the spousal annuity requirements was an oversight which should be corrected.

9) Clarification of the 50% Rule

In a defined contribution plan, the qualified pre-retirement death benefit is defined by reference to "50% of the account balance." Most, but not all, defined contribution plans provide for full vesting of the account balance upon death. Many observers believe that for those plans which do not provide full vesting upon death, the 50% reference was intended to mean 50% of the vested balance. There should be clarification on this point.

10) Treatment of Loans

The proposed bill solves many of the problems imposed by REA when attempts are made to grant participant loans using vested interests as security. However, one problem left unsolved involves the participant who is unmarried at the time the loan is extended, but later becomes married. Loans made under this circumstance should receive the same protection as loans made before April 18, 1985.

11) Break In Service Rules - Elapsed Time Plans

Guidance should be provided relative to application of break in service rules to plans using elapsed time concepts. This guidance could take the form of statutory provisions. Alternatively, it could take the form of Congressional instructions, to Treasury, to publish regulations on the subject promptly. At present, this subject does not appear to be as high on the regulatory priority list as it should be.

12) Broadening of Gift Tax Exemption

In our discussion of DEFRA corrections, we raised objection to the repeal of §2517. We believe one of the REA corrections should involve extension of the exemption of §2517 to include a "gift" given by the participant's spouse who consents to an election away from spousal benefits.

13) Definition of Accrued Benefit

Attention should be given to the question of whether full subsidization of the qualified pre-retirement death benefit is part of the accrued benefit. For example, is full subsidization subject to the anti cutback rule?

For another example, suppose a vested terminator receives a lump sum settlement. Must the settlement include the value of the future pre-retirement spousal protection which would otherwise have been available? If so, must one consider the probability that a single employee will become married some time after employment termination?

It should be noted that depending on the answers to these questions, it may be necessary to amend definitions of actuarial equivalence to include marriage probabilities and marriage dissolution probabilities.

We suggest the position that full subsidization is not part of the accrued benefit for vesting and anti-cutback rules.

* * * * * *

We would be eager to meet with members of the committees or their staffs to develop and clarify any of these recommendations.

American Society of Pension Actuaries
1413 K Street N.W.
Washington, D.C. 20005
(202)737-4360

by Edward E. Burrows
Edward E. Burrows, M.S.P.A.
Chairman, Government Affairs Committee

jh

STATEMENT OF SENATOR BARRY GOLDWATER
BEFORE THE SENATE FINANCE COMMITTEE
ON THE TECHNICAL CORRECTIONS ACT OF 1985 - S. 814

JUNE 5, 1985

Last year, during deliberations of the Tax Reform Act of 1984, it was brought to the Committee's attention that certain provisions of the Act jeopardized the tax-exempt financing of a major project important to several cities and other public entities in Arizona and in California. Congress responded and gave specific protection in the 1984 Tax Reform Act to preserve the tax exempt status of interest on obligations issued with respect to the Mead-Phoenix Transmission Line Project. It now appears that a provision of the Technical Corrections Act of 1985 (S. 814) would undermine that protection.

The Mead-Phoenix Transmission Line Project is a joint effort of the Salt River Project Agriculture Improvement and Power District in Phoenix, Arizona; several California cities including Los Angeles, Anaheim, Burbank, Glendale, Pasadena and Riverside; the Modesto Irrigation District; and the Western Area Power Administration (Western) of the U. S. Department of Energy. The project is a high-volume direct current transmission line betwen the Hoover Dam area and the Phoenix area which will allow Arizona to receive its increased entitlement of power from the Hoover Generation Station and enable the public entities involved to make economical energy purchases and transfers between the two states.

The participation of Western in the Project requires it to also participate in payment of financial obligations issued on behalf of the Project. However, the 1984 Tax Reform Act specifically prohibits bonds which are federally guaranteed to be tax-exempt. The payments by Western could be viewed as a federal guarantee of the issue obligations and thus this federal guarantee provisions jeopardizes in the 1984 Tax Reform Act the tax-exempt status of the Mead-Phoenix Project. Because of this potential jeopardy, Congress responded by including a specific grandfather clause {Section 632(d)} in the 1984 Tax Reform Act preserving the project's tax-exempt financing.

The 1984 Tax Reform Act also contains a "consumer loan bond" provision. This consumer loan bond provision could also have jeopardized the tax-exempt status of the Mead-Phoenix Project. However, a transitional rule in the Act {Section 631 (c)(3)} excludes projects such as the Mead-Phoenix Project from this provision by virtue of the fact that for these projects "a binding contract to incur significant expenditures was entered into by October 19, 1983." Bonds issued for the Mead-Phoenix project would have otherwise been "consumer loan bonds" because of the contractural arrangements previously entered into by Western (a non-exempt entity).

Now, however, Section 169 of the Technical Corrections Act of 1985 would revise the transitional rule in Section 631 (c)(3) of the 1984 Tax Reform Act so that the "consumer loan bond" provisions would apply to the Mead-Phoenix Project. Thus, Congress' specific protection of the tax-exempt status of bonds for the Mead-Phoenix Project in the 1984 Tax Act, would be negated by these "technical corrrections."

I believe that it is clear that Congress intended to preserve the tax-exemption of interest on obligations issued for the Mead-Phoenix Project and that it is reasonable to expect Congress to preserve this exemption in the Technical Corrections Act.

I would therefore appreciate the Committee's consideration of this problem and seek its assistance in finding a favorable solution.

STATEMENT OF BARBARA F. VUCANOVICH, M.C.
ON S. 814
SENATE FINANCE COMMITTEE

Mr. Chairman:

White Pine County is an economically distressed county in my District. It became so when it lost its principal economic activity, copper mining and smelting. To alleviate this distress, the Nevada legislature in 1979, authorized the White Pine Power Project, a 1500 megawatt coal-fueled electric generation facility, pursuant to Nevada's County Economic Development Revenue Bond law. The project will bring electric power to rural Nevada and to metropolitan regions of Nevada and California. It is to be financed by tax exempt revenue bonds.

The project will provide 2,600 direct and 554 support jobs during its four to six year construction phase and 530 direct and 212 support jobs during its 35 year post-construction life. (The County's population is barely 9,000.) The project will also provide payments in lieu of tax to the State of Nevada and its counties of $448,000,000 in 1983 dollars over the project life.

The Technical Corrections Act of 1985 provides that the "grandfather" rule (Section 631 (c) (3) of the Tax Reform Act of 1984) will not apply to Section 103 (o) of the Internal Revenue Code. This legislation would cause the loss of the tax exempt feature of the bonds of the White Pine Power Project issued after July 18, 1984, because a "significant portion," i.e., 5 percent or more, of the bond proceeds could be deemed directly or indirectly "loan" to non-exempt persons. (Nevada Power Company in southern Nevada and the Sierra Pacific Power Company and Mt. Wheeler Power in northern Nevada have reserved rights in the aggregate to purchase 25 percent of the capacity of the project.) Project bond counsel advise me that they could not give an unqualified opinion that the project's financing arrangements would not constitute "indirect loans." Without tax exempt financing the project more than likely will not go forward. Thus, denial of tax exempt financing to it will not produce any federal revenue.

This project has been in the planning stage since 1979 and in excess of $20,000,000 has been expended or committed for expenditures to finance the development and study costs associated with its ultimate construction. These funds have been used or committed to conduct extensive feasibility and environmental impact studies to determine the feasibility of the project itself, satisfy the mandate of the National Environmental Protection Act and obtain the water, air quality and right-of-way permits required for the project. All this was done in conformity with and good faith reliance upon existing federal laws.

I urge that this project be "grandfathered," that is, that its obligations not be treated as private loan bonds and not be made subject to section 103 (o) of the Internal Revenue Code. I think fairness requires this.

Thank you for your consideration of this urgent request.

Barbara F. Vucanovich, M.C.

AMERICAN ACADEMY OF ACTUARIES

STATEMENT TO
THE SENATE COMMITTEE ON FINANCE

ON BEHALF OF THE
SUBCOMMITTEE ON HEALTH AND WELFARE PLANS
OF THE AMERICAN ACADEMY OF ACTUARIES

HEARINGS ON THE TECHNICAL CORRECTIONS ACT OF 1985

JUNE 11, 1985

On June 5, 1985, the Senate Committee on Finance held hearings on the Technical Corrections Act of 1985. The comments below are submitted for the record of those hearings.

PURPOSE

The American Academy of Actuaries ("Academy") appreciates the opportunity to submit comments on the Technical Corrections Act of 1985. This document contains comments on issues relating to premium stabilization reserves, setting actuarial assumptions, disability income benefits, and the definition of a qualified actuary.

BACKGROUND

The Academy is a professional association of over 7,600 actuaries involved in all areas of specialization within the actuarial profession. Included within our membership are approximately 85% of the enrolled actuaries certified under the Employee Retirement Income Security Act of 1974 (ERISA), as well as comparable percentages of actuaries specializing in actuarial services for other employee coverages such as life, health and disability programs. As a national organization of actuaries, the Academy is unique in that its membership consists of actuaries with expertise in all areas of actuarial specialization.

The Academy does not advocate major public policy positions, in such areas as tax legislation, which are not actuarial in nature. The Academy views its role in the government relations arena as providing information and actuarial analysis to public policy decision-makers, so that policy decisions can be made with informed judgment. It is our belief that the training and experience of Academy members allow a unique understanding of current practices in employee benefits. Our intention is to communicate that understanding in ways that assist policy decision-makers.

COMMENTS

Premium Stabilization Reserves

The description of the Technical Corrections Act of 1985 states that certain amounts held by an insurance company for a reasonable premium stabilization reserve may not be treated as a fund for purposes of Section 419.

A premium stabilization reserve, in order to be considered reasonable, should reflect the nature of the coverages to which it applies. A coverage that is characterized by frequent, relatively small claims requires a smaller reserve than a coverage characterized by large, infrequent claims. Furthermore, a larger reserve should be considered reasonable on coverages where fewer lives are exposed. Claim costs can fluctuate significantly from year to year, and a reasonable premium stabilization reserve can provide protection against fluctuation.

The level of reserves which might be considered reasonable also depends on the nature of the group insured. Where a premium is collected directly from individuals covered, it is desirable to maintain those premiums at a stable level from year to year. If premiums increase significantly, covered lives who are generally better risks will drop out of the group. The remaining lives will require further premium increases, and the plan will continue to decline in size. Thus, a stabilization reserve for this sort of group should be significantly higher than for a conventional employer plan in order to prevent a declining enrollment spiral.

Examples of groups where higher levels of reserves are reasonable are employee-pay-all plans, associations of individuals, and to a lesser extent, associations of employers and other multiple employer plans.

The appropriate level of reserves on a particular group can be determined based on type and design of benefit provisions, and the nature of the group covered. This level of reserve can vary from group to group.

Actuarial Assumptions

As in any actuarial assignment, the setting of appropriate assumptions is a key ingredient in establishing funding levels. The provisions relating to welfare benefit plans funded through VEBAs in the Deficit Reduction Act of 1984 require that assumptions be reasonable in the aggregate. This is quite appropriate and follows the precedent set by ERISA in the pension area. However, the Conference Report goes further and indicates that "in addition to requiring that actuarial assumptions are to be reasonable in the aggregate, Treasury regulations may prescribe specific interest rate and mortality assumptions to be used in all actuarial calculations." Such a simplistic approach would ignore the fact that experience is different from plan to plan for a variety of reasons (age/sex composition, benefit utilization tendencies of group, nature of work, geographical area, etc.). Attempting to mandate any set of uniform assumptions will inevitably result in inappropriate assumptions being used for large numbers of plans. Setting appropriate actuarial assumptions requires the application of actuarial judgment to fit the facts and circumstances at hand.

We are concerned at the prospect that specific actuarial assumptions might be prescribed for funded welfare benefit plans. We believe the approach used in ERISA for setting actuarial assumptions for pension valuations is much more appropriate. The treatment of future increases in claim costs on post-retirement benefits is of particular concern. Under the Deficit Reduction Act of 1984, increases in claim costs due to any source such as inflation, changes in utilization patterns, etc. could only be funded each year after the increase has occurred, rather than through advance funding. The net effect is that these limits in general will be substantially below the full, level cost of the benefits promised. This provision effectively discourages employers who wish to adequately fund retiree welfare benefits as they do pension plans.

Definition of Disability

The Conference Committee has expressed its intent that with regard to welfare benefit funds established for providing disability benefits that a disability be defined as "any serious physical or mental impairment which causes an inability to perform a substantial portion of the duties of an individual's ordinary employment." The Committee further expressed their intent that funding of claims with respect to an indefinite period of time be allowed only in connection with disabilities that are determined to be long term disabilities. Such disabilities are "those which (1) a medical evaluation determines is expected to last more than 12 months and (2) has persisted for at least five months."

The Conference Committee's definition of disability has two serious defects. First, it does not recognize disabilities that are not expected to last twelve months under a long term disability plan. Many serious disabilities will persist beyond five months, but will terminate either by death or recovery within one year of the onset of disability. Second, the definition requires that the claim persist for at least five months and many long term disability plans employ a shorter elimination period.

There are several definitions of disability which are commonly used in conjunction with disability income plans. The definition which is incorporated into a particular plan document will reflect the plan sponsor's employee benefit philosophies and policies, as well as the level of costs it is willing to incur.

A plan sponsor is not likely to modify the definition of disability within its plan document to conform with the Conference Committee's definition. As a result, one definition of disability would be used for benefit determination and a second would be employed for the purposes of determining qualified funding limits. This qualification of certain disabilities for the purpose of determining funding limits could result in an unrelated business income tax to the fund if it is funded to meet its future obligations according to reasonable actuarial assumptions as to morbidity, mortality and interest. On the other hand, if fund accruals are limited to be in accord with the Conference Committee's definition of disability, the fund may be insufficient to meet its future obligations.

We recommend that a disability income plan funding level be determined using actuarial techniques and reasonable assumptions as to morbidity, mortality and interest reflecting the definition of disability incorporated into the plan document.

Short Term Versus Long Term Disability Plans

The Conference Committee limits funding for short term disability plans to five months of benefit payments. Short term disability plans most commonly provide for three, six or twelve months of payment. We recommend that a short term disability plan funding limitations be defined in a manner consistent with the plan maximums.

Definition of Qualified Actuary

Actuarial analysis of employee welfare benefit plans demands the expertise of specialists in welfare plans, employing actuarially sound methods which reflect characteristics unique to those particular welfare plans. Included are characteristics such as the analysis of past health care utilization, adjustments to reflect the changes of plan design or demographics, assessments of claim liabilities, analysis of claim trends (including inflation and utilization patterns) and projections of financial experience. Only actuaries specializing in these programs are properly qualified to so examine employer welfare benefit plans. For example, an enrolled actuary under ERISA has satisfied qualification standards for practice in the pension area, but such an individual may or may not be qualified when it comes to employee health and welfare plans. We strongly urge that direct participation of the actuarial profession be utilized in defining necessary qualifications for actuarial services to these plans. The Academy has a strong commitment to professional standards and self-regulation. We are prepared to work closely with the government if regulations regarding actuarial qualifications are to be developed.

SUMMARY

The actuarial profession, as represented by the American Academy of Actuaries, appreciates the opportunity to present our testimony and wishes to offer any possible assistance to the governmental bodies involved with employee welfare benefit plans. Because we understand past and present practices in this area, we believe that we can assist in identifying and weighing the merits of employee benefit plan alternatives for the future. We hope the comments presented in this statement will be useful in helping Congress deal appropriately with the complex area of employee benefits.

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**AMERICAN
BANKERS
ASSOCIATION**

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

James D. McLaughlin
Government Relations
Counsel
202 467-5778

May 20, 1985

Senator Bob Packwood
Chairman
Committee on Finance
U.S. Senate
Washington, D.C.   20515

Dear Mr. Chairman:

I am writing on behalf of the nearly 4,000 trust departments of the American Bankers Association's member banks to express our support for Section 105(a) of S. 814, the Technical Corrections Act of 1985. The bill is scheduled for hearing on June 12.

As enacted in 1984, IRC Section 643(e) requires two or more trusts to be consolidated for income tax purposes if the trusts had substantially the same grantor (treating husband and wife as the same person), substantially the same beneficiary or beneficiaries, and a principal purpose of the trusts is the avoidance of tax.

That law presents enormous difficulties for trustees who do not know, nor, prior to its enactment, had any reason to ask about other trusts which may have been established by the grantor or the grantor's spouse. In most cases the only way a fiduciary could ascertain the existence of other trusts is from the grantors themselves, but they may be deceased. In addition a great many difficulties relating to sharing of information on a timely basis were left to be worked out by fiduciaries.

Section 105(a) would make the 1984 law inapplicable to trusts which were irrevocable on March 1, 1984, except for amounts contributed to corpus after that date. ABA supports this provision. Insofar as it goes it relieves fiduciaries of a seemingly impossible burden.

We understand that Treasury has taken a different position but we strongly believe the provision should remain in the bill as is. While even after adoption of this proposed change a great many details and clarifications will have to be worked out in the regulations, the separation of "old" trusts goes a long way to narrowing the impact of the provision by limiting it to trusts which have been established recently. ABA will be pleased to discuss this proposal in greater detail with the committee staff if that would be helpful.

We request that this letter be made a part of the hearing record of S. 814.

Sincerely yours,

James D. McLaughlin

ACPC

THE AMERICAN COLLEGE OF PROBATE COUNSEL

10964 West Pico Boulevard • Los Angeles, California 90064

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Bridgeport, Connecticut

The attached written statement is submitted by the Estate & Gift Tax Committee of the American College of Probate Counsel, of which Malcolm A. Moore, 4200 Seattle-First National Bank Building, Seattle, WA 98154,(206) 622-3150, is the Chairman.

The written statement has been prepared by the Estate & Gift Tax Committee of the American College or Probate Counsel (the "College"). The membership of the Estate & Gift Tax Committee of the College is listed on Exhibit B attached to the written statement.

The American College of Probate Counsel is composed of more than 2,450 experienced and seasoned lawyers that specialize in the practice of trusts and estates law and related tax matters. The improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximim extent possible the disposition of property and the administration of estates in this country, has been a major and continuing effort of the College from the day it was first organized over 35 years ago.

The attached written statement relates to Section 6660 (the understatement valuation penalty section enacted as Section 155(c) of the Tax Reform Act of 1984). While part of the statement calls for repeal of that section as it applies to the estate tax, much of the paper relates to technical corrections needed in the statute, whether it applies only to the gift tax, or applies to both the estate and gift tax.

Please Address Reply to: Malcolm A. Moore, 4200 Seattle First National Bank Building, Seattle, WA 98154, (206) 622-3150

SECTION 6660 SHOULD BE REPEALED AS TO THE ESTATE TAX AND SUBSTANTIALLY MODIFIED AS TO THE GIFT TAX

Section 155(c) of the Tax Reform Act of 1984 added to the Internal Revenue Code an entirely new section 6660, creating an addition to tax in the case of a valuation understatement for purposes of estate and gift taxes. Section 6660(a) provides that the addition to tax is a percentage of the underpayment of tax due to the understatement of value, but section 6660(d) exempts underpayments of less than $1,000. Under section 6660(b), the addition is 10% of the underpayment if the claimed valuation is 50% or more but not more than 66-2/3% of the correct valuation, 20% if the claimed valuation is 40% or more but less than 50% of the correct valuation, and 30% if the claimed valuation is less than 40% of the correct valuation. Section 6660(e) gives the Secretary the authority to waive the addition to tax if the taxpayer shows that there was a reasonable basis for the claimed valuation and that such claim was made in good faith.

It is submitted that this provision requires drastic revision and partial repeal. However, to analyze the section in detail in support of this suggestion, some historical review is required.

Section 6653(a)(1) of the Code provides for an addition to tax if any underpayment of tax is due to negligence or intentional disregard of rules and regulations without intent to defraud. The addition to tax is 5% of the underpayment. However, section 6653(a)(1) is limited to underpayment of income tax, gift tax and windfall profit tax. It does not apply to underpayment of estate tax. Provision for a 5% penalty with regard to underpayment of income tax originated with section 250(b) of the Revenue Act of 1918. A comparable penalty was added for underpayment of gift tax in the Gift Tax Act of 1932, section 520(a). However, at no time has such a penalty ever applied to underpayment of estate tax, although the 50% fraud penalty imposed by section 6653(b)(1) applies to estate tax as well as to the other taxes mentioned.

The 5% negligence penalty and the 50% fraud penalty for underpayment remained the sole penalties for underpayment until 1981. In that year, the Economic Recovery Tax Act [ERTA] added new section 6659 to the Code, providing for an addition to tax in the case of a valuation overstatement for purposes of the income tax. The addition to tax was expressed as a percentage of the underpayment of tax due to the overstatement of value, with underpayments of less than $1,000 exempted. The addition was set at 10% of the underpayment if the claimed valuation was 150% or more but not more than 200% of the correct valuation, 20% if the claimed valuation was more than 200% but not more than 250% of the correct valuation, and 30% if the claimed valuation was more than 250% of the correct valuation. The Secretary was given authority to waive the penalty upon a showing that there was a reasonable basis for the valuation claimed and that such claim was made in good faith. Section 6659, as added to the Code in 1981, closely parallels new section 6660 [the undervaluations which give rise to percentage additions to tax under section 6660 are the reciprocals of the overvaluations in section 6659].

In the House Report on ERTA, H.R. 97-201, 97th Cong., 1st Sess., June 24, 1981, pp. 243-244, and in the General Explanation of ERTA, prepared by the Staff of the Joint Committee, the existence of negligence and fraud penalties for underpayment of income tax was noted, but a specific penalty was said to be necessary because of the large number of valuation disputes outstanding [stated to be 500,000]. The House Committee Report also noted that the then interest rate on deficiencies was below the then prevailing cost of borrowing, making overvaluations attractive. In expanding on the new provision and explaining how it would work, the Staff of the Joint Committee gave as its sole example of overvaluation a case of an overvalued painting given to charity.

With a few minor technically clarifying amendments, section 6659 remained as enacted until the 1984 Act. In that Act, in addition to enacting section 6660, Congress took significant action with respect to overvaluations of property.

Section 155(a) of the Act, which is not a part of the Internal Revenue Code, directed the Secretary to issue Regulations requiring individuals, closely held corporations and personal service corporations claiming deductions under section 170 of the Code for contributions of property other than publicly traded securities to obtain qualified appraisals of the property contributed, and to attach such appraisals, plus other information, to the return on which the deduction is claimed.

A "qualified appraisal" is defined as one prepared by a "qualified appraiser" which includes a description of the property appraised, the fair market value of such property on the date of contribution, the specific basis for the valuation, a statement that the appraisal was made for income tax purposes, the qualifications of the appraiser, the signature and TIN number of the appraiser, and any other information required by Regulations. A "qualified appraiser" is one who is qualified to appraise the type of property involved and who is not the taxpayer, a party to the transaction in which the taxpayer acquired the property, the donee, any person employed by or related to any of such persons, or any person whose relationship to the taxpayer would cause a reasonable person to question the appraiser's independence. Further, a appraisal will not be a qualified appraisal if the fee is based on a percentage of the value of the appraised property, unless the fee is based on a sliding scale paid to a generally recognized association regulating appraisers. Such qualified appraisals are to be required whenever the claimed value of similar items and property contributed to charity (other than publicly traded securities), plus the claimed value of all similar items of property contributed, exceeds $5,000 ($10,000 if such property is nonpublicly traded stock).

Section 155(b) of the 1984 Act added new section 6050L to the Code, requiring charitable donees to file information returns in the event of any disposition of gift property within 2 years of its receipt.

Finally, in section 155(c)(1) of the Act, Congress modified section 6659 to eliminate a previous safe haven for property held by the taxpayer for more than 5 years and to provide that the addition to tax in the case of any underpayment attributable to an overvaluation of property for which a charitable deduction was claimed is a flat 30%, regardless of the percentage of overvaluation. In any such case, waiver of the penalty is not permitted unless the Secretary determines that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser and, in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

In explaining these changes, the Senate Committee Report discussed at considerable length the problem presented by overvaluations of property contributed to charity and the playing of the "audit lottery" by taxpayers claiming excessive charitable deductions. Because of these concerns, the Committee stated that "stronger substantiation and overvaluation provisions should be made applicable to charitable contributions of property." Without further discussion, the Report then commented that the general overvaluation penalty "should apply whether the property is held for fewer or more than five years, and that it is equally important to deter incorrect valuations for estate and gift tax purposes."

From this historical analysis, it is clear that Congress has consistently been more concerned about underpayment abuses in connection with income and gift taxes than the estate tax. While the fraud penalty applies to underpayment of estate tax, the negligence penalty to this day is inapplicable to such tax. Further, when valuation disputes were first perceived as requiring a specific penalty, it was in the context of intentional overvaluation of property for which an income tax deduction was claimed. Although the original overvaluation penalty provisions were not limited to charitable contributions, the legislative history makes clear that such was the principal problem area. The 1984 amendments to section 6659 and subsections (a) and (b) of section 155 of the 1984 Act were directed at precisely that target. Expansion of the penalties for valuation error to the estate tax area appears to have been no more than an afterthought.

Making inter vivos deductible gifts of property to charity is, self-evidently, elective, and such gifts are widely utilized for income tax reduction purposes. Further, in making such a gift, the donor is able to select the item of property to be donated. Under such circumstances, the temptation to lean a little on the valuation scale so as to obtain a larger reduction of tax is obvious. A similar motivation to value an item of property selected for a taxable gift at the low end of the valuation scale may also be apparent.

However, the estate tax presents an entirely different situation. Assuming that, in most instances, the event which triggers estate tax is involuntary, determination of the correct tax requires the correct valuation of each and every item in the decedent's estate. It is, of course, true that valuation of certain types of assets is difficult and that serious differences of opinion may exist between an estate's representative and an IRS auditor. However, it is not the estate's fault that this is so, whereas it might be contended that problems caused by selection of a difficult-to-value asset for either a deductible or a taxable gift are occasioned by the donor. In light of the lack of legislative history behind the need for an estate tax undervaluation penalty, the apparent lack of abuse in such valuations, and the substantive and technical shortcomings of the statute set forth later in this document, Section 6660 should be limited to the gift tax until it has been shown that its expansion solves a genuine estate tax problem. The existence of such a problem has not as yet been demonstrated. No evidence of egregious or wide-spread undervaluation of property for estate tax purposes has been presented.

Even if it were to apply only to the gift tax, Section 6660 requires significant modification, both substantive and technical. Section 6659(g)(1) defines an "underpayment", to which the penalties imposed by that section apply, by reference to section 6653(c)(1), which, in turn, incorporates the definition of a "deficiency" set forth in section 6211, i.e., the net tax owed. Thus, for purposes of the overvaluation section, no penalty is imposed if there is no deficiency in income tax. Section 6660, however, contains no definition of "underpayment", and presumably the penalty imposed by that section would be due even if a reduction in the value of other items of property eliminated any deficiency. A reference to section 6653(c)(1) is required.

Further, the de minimis exception of section 6660 is far too small in the gift or estate tax context, where gifts will frequently be made to use up a donor's unified credit resulting in transfers in excess of $600,000 by 1987. A $1,000 de minimis exception is simply inadequate. There should be no penalty unless the underpayment represents a significant percentage of the total tax. The 10%-$5,000 test of section 6661 should be incorporated in section 6660.

There will be significant questions regarding whether there has even been an understatement, and if so, how is the penalty to be computed. For example, suppose that three items of property are undervalued. The first is valued at 52% of its correct value; the second at 45%, and the third at 38%. If the effect of the three undervaluations is to cause the marginal tax rate to drop from 49% to 43%, completely by-passing the 45% bracket, how are the penalties to be computed? Should the underpayment attributed to the greatest undervaluation be computed at the highest rate? Should an average rate be used? It is suggested that a technical amendment be adopted to make clear that all valuation understatements should be aggregated and the proper percentage determined with respect to the total and applied to the underpayment resulting therefrom.

Finally, the Regulations should make clear what constitutes a reasonable basis for a claimed valuation, as well as what constitutes good faith in making such claim. Proposed Regulation § 1.6661-6 offers some guidance in this area, but is itself inadequate. At the very least, the Regulations should provide that there is a reasonable basis for a value based on a qualfied appraisal made by a qualified appraiser as those terms are used in section 6659(f). The Regulations should also recognize that, in some cases, comparable property does not exist and, in such cases, even greater weight must be given to a qualified appraisal. Two qualified appraisals should require waiver of the penalty. In addition, the Act should be amended, and the Regulations should be issued consistent therewith, to eliminate any penalty where the taxpayer's valuation approach is supported by substantial authority such as court decisions supporting use of substantial discounts in the valuation of closely held stock. Even though the IRS does not agree with such decisions and continues to litigate the issue, it should not be entitled to assert a penalty against those who rely on favorable court decisions. See proposed Regulation § 1.6661-3.

The Explanation of the Act should also express Congressional intent that the requirements of good faith and fair play extend in two directions. While taxpayers may be subject to a penalty for undervaluation, no penalty presently applies if the Service asserts an excessive value. Direction should be given to examining officers to temper their enthusiasm for collecting tax with a realistic approach to value. Experience under the Act may ultimately demonstrate the need for enactment of a penalty against the Service if agents utilize section 6660 as a threat to obtain agreement to asserted deficiencies with respect to the putative undervalued asset or on some other basis.

A suggested revision of section 6660 is attached hereto as Exhibit A.

If section 6660 were to remain applicable to the estate tax, further revisions would be required. Under new section 2210, an ESOP may be required to pay a portion of the estate tax otherwise due from an estate which transfers employer securities to it. In such case, under new section 6018(c)(2), the plan administrator is required to file an estate tax return with respect to such portion of the tax. Section 6660 should be amended to make clear that the

ESOP is not liable for any penalty due to undervaluation.

The addition to tax appears to apply even where the understatement of value results from failure of the estate to qualify for special use valuation under section 2032A. Such a situation does not involve a valuation abuse of the type at which the section appears to be aimed and the section should be amended to make this clear.

Expansion of the de minimis rule is especially vital if the section applies to the estate tax. Even if one were to argue that a $1,000 floor is appropriate with respect to underpayments of income tax or gift tax attributable to voluntary transfers of overvalued property to charity or undervalued property to others (which the College asserts is not the case with the gift tax), it is entirely inappropriate where applied to involuntary transfers subject to estate tax. Without considering such inherently difficult-to-value assets as closely held corporation stock, property subject to options or buy-sell agreements, tax shelter partnerships, mineral interests and the like, virtually all estates will include items such as jewelry, furniture and furnishings, or a residence, as to which valuation estimates may well differ by more than one-third. To apply a 10% penalty in all such cases is intolerable.

EXHIBIT A

SEC. 6660. ADDITION TO TAX IN THE CASE OF VALUATION UNDER UNDERSTATEMENT FOR PURPOSES OF THE ~~ESTATE OR~~ GIFT TAXE~~S~~.

(a) Addition to the Tax.- In the case of a substantial ~~any~~ underpayment of a tax imposed by ~~subtitle B~~ chapter 12 (relating to ~~XXXXXX and~~ gift taxes) which is attributable to a valuation understatement, there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributed.

(b) Applicable Percentage.- For purposes of subsection (a), the applicable percentage shall be determined under the following table:

If the valuation claimed is the following percent of the correct valuation -	The applicable percentage is
50 percent or more but not more than 66-2/3 percent	10
40 percent or more but less than 50 percent	20
Less than 40 percent	30

(c) Valuation Understatement Defined.- For purposes of this section, there is a valuation understatement if the value of an item of ~~any~~ property claimed on any return is 66-2/3 percent or less of the amount determined to be the correct amount of such valuation unless the value claimed on the return with respect to such item of property is or was supported by substantial XXXXX authority. For purposes of sub-section (b), the valuation claimed for all such undervalued items of property shall be determined as a percentage of the correct valuation of all such items.

(d) ~~Underpayment-Must-Be-at-Least-$1,000.--This section-shall-not-apply-if-the-underpayment-is-less than-$1,000-for-any-taxable-period-(or-in-the-case-of the-tax-imposed-by-chapter-11,-with-respect-to-the estate-of-the-decedent).~~ Substantial Underpayment Defined.- For purposes of this section there is a substantial underpayment of tax if the amount of the underpayment exceeds the greater of -

(i) 10% percent of the tax required to be paid for the taxable period; or

(ii) $5,000.

(e) Authority to Waive.- The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation claimed on the return and that such claim was made in good faith.

(f) Underpayment Defined.- For purposes of this section, the term "underpayment" has the meaning given to such term by section 6663(c)(1).

STATEMENT OF THE
AMERICAN COUNCIL OF LIFE INSURANCE

I. COMMENTS ON H.R. 1800, THE TECHNICAL CORRECTIONS ACT OF 1985

A. Definition of Welfare Benefit Fund

Background. Section 151(a)(8) of the technical corrections bill would clarify the definition of welfare benefit "fund" in Section 419(e)(3) of the Code to exclude amounts held by an insurance company pursuant to certain insurance contracts. The legislative history of Section 419 states that the primary purpose of the welfare benefit fund provisions is to prevent employers from taking premature deductions for expenses which have not yet been incurred [H.R. Rep. No. 861, 98th Cong., 2d Sess. 1155 (1984)]. The proposed technical correction implements the Congressional policy that typical group insurance contracts are not subject to the various limitations on welfare benefit funds.

The ACLI urges that the proposed technical correction be enacted. The ACLI is concerned that ambiguous language in the Committee reports underlying the 1984 Act could be misinterpreted to impact adversely on a wide variety of common life, accident and health insurance benefits that are not designed to generate premature deductions. It is essential that the proposed technical correction be enacted to state expressly Congress' intent not to disrupt bona fide group insurance plans which provide the security of insurance protection to millions of employees and their dependents.

Section 151(a)(8) of the bill would exclude amounts held by an insurance company pursuant to an insurance contract if: (1) there is no guarantee of a renewal of the contract; and (2) other than current insurance protection, the only payments to which the employer or employees are entitled are experience-rated refunds or policy dividends which are not guaranteed and which are determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries. This statutory exclusion from the definition of fund would apply only where any experience-rated refund or policy dividend payable to an employer with respect to a policy year is treated by the employer as received or accrued in the taxable year in which the policy year ends.

The proposed technical correction would exclude from the definition of "fund" typical experience-rated group insurance plans. The "no guarantee of renewal", "no guarantee of dividend" and "other factors" requirements are included in the technical correction to describe features of bona fide group insurance plans that distinguish such plans from "cost-plus" or "self-insured" arrangements. Because of these features, the premiums paid by the employer are subject to a risk of loss and, therefore, are not to be treated as contributions to a fund.

In practice, the "no guarantee of renewal" feature under a typical group insurance contract takes one of two forms: the insurer has a right for future policy years either to cancel the contract or to change the premium rate. In these insured arrangements, the employer is not guaranteed a return of any part of his premium payments because any experience-rated refund or policy dividend is determined, in part, by factors (e.g., a risk charge) in addition to benefits paid. As a result, the insurer assumes the risk that benefits will exceed premiums paid and the employer assumes the significant economic risk that he will not be refunded any portion of his premiums. Thus, the technical correction would properly exempt the typical experience-rated group insurance policy, but would not exempt cost-plus or similar arrangements based solely on the employer's experience where comparable risks are not present.

Section 151(a)(8) Should Be Enacted. There are several reasons why the proposed technical correction is appropriate and should be enacted. First, the provision recognizes the fundamental differences between insured and uninsured welfare benefit arrangements. Specifically, the employer who provides benefits through an insured arrangement obtains the insurer's benefit guarantees in exchange for premium payments. In return for this third-party guarantee, the employer must forego: (1) potential savings in state premium taxes (typically 2-4% of employer contributions) and other retention charges; (2) the ability to control the investment of his contributions and to establish claims reserves; (3) the ability to control cash flow and the level of contributions to the plan; and (4) discretion in determining administrative practices and charges. The proposed exclusion of insured arrangements does not affect these potential competitive advantages of self-insured arrangements--it simply carries out the Congressional intent that bona fide insured plans, under which the employer has relinquished the control available with self-insurance, were not intended to be subject to the tax law's funding constraints aimed at uninsured plans.

Second, the proposed technical correction minimizes the ability of an employer to obtain current deductions for amounts allocable to future benefits in accordance with the intent of the law. This is because the exclusion would apply only if the employer includes in income the amount of any experience-rated refund or dividend for the policy year to which the refund or dividend relates. Consequently, the provision would not permit arrangements that effectively circumvent the Congressional policy to limit the ability of employers to use the tax laws to benefit from the so-called "time value of money."

Third, the proposed technical correction would provide much needed certainty that common types of insured welfare plans will not be treated as welfare benefit funds. This certainty is essential because: (1) the legislative history of the welfare benefit fund provisions contains substantial ambiguity and potentially confusing language with respect to the intended scope of the regulations under Section 419(e)(3); (2) the new rules are scheduled to take effect on January 1, 1986, but, it is extremely unlikely that final, and possibly even proposed, regulations will be published by that date; and (3) in the interim, the status of thousands of plans covering millions of workers and their beneficiaries is open to question with the potential for substantial disruption if overly broad regulations are issued. Moreover, uncertainty will significantly impede the establishment of new plans. The proposed technical correction would properly remove the existing cloud that hangs over a major segment of this important aspect of the insurance industry.

In its statement before the Committee, Treasury opposed the proposed technical correction in Section 151(a)(8). The ACLI strongly disagrees with Treasury's suggestion that the proposed technical correction be abandoned. Treasury's opposition to Section 151(a)(8) appears to be based primarily on the erroneous premise that insured plans are comparable to self-insurance and that group insurance should be classified as a "fund." But, in enacting the welfare benefit fund provisions, Congress recognized that bona fide insurance arrangements do not involve potential premature deductions or the employer control inherent in uninsured plans. Congress did not intend to subject insured arrangements to the new tax rules. Thus, Treasury's arguments do not warrant deletion of the proposed technical correction.

Treasury did agree, however, that a technical correction is needed to insure that there is no "chilling effect" on the retention or establishment of arrangements offered by insurance companies. Treasury indicates that such a technical correction could provide that an account held by an insurance company will not be treated as a "fund" before six months following the issuance of final regulations. Treasury's statement recognizes that regulations defining particular arrangements as "funds" should not be effective immediately upon promulgation because such regulations may include arrangements which employers reasonably did not believe would be considered "funds." In such situations, employers should have a reasonable opportunity to modify their arrangements to conform to the positions reflected in the final regulations. The industry endorses, therefore, Treasury's suggestion that the law be amended to provide that any arrangements defined in final regulations to be a "fund" will not be subject to the funded welfare benefit fund rules until six months after the promulgation of such final regulations.

Recommendations. For the foregoing reasons, the ACLI strongly recommends that the proposed technical correction in Section 151(a)(8) be enacted and endorses Treasury's suggestion regarding the effective date of final regulations defining "fund". We also suggest confirmation that the "no guarantee of a renewal" requirement is satisfied where, as is the case in typical group insurance plans, the insurer has the right for future policy years either to cancel the contract or to change the premium rate.

B. Distribution Rules Applicable to Annuity Contracts

Proposals:

1. In Section 126(a) of H.R. 1800, eliminate the reference to annuity contracts described in Section 403(b) (proposed subclause (ii) of Paragraph 5(A) and eliminate the proposal in Section 152(a)(3) of H.R. 1800 to subject such annuity contracts to the distribution rules of Section 401(a)(9) so that Section 403(b) annuity contracts will be subject to the distribution rules of Section 72(s);

2. Clarify whether the distribution rules of Section 72(s) or 401(a)(9) apply to annuity contracts issued in connection with

deferred compensation plans meeting the requirements of Section 457 and make it clear that whichever rules apply, they are the exclusive distribution rules for such contracts.

Reasons for change:

1. Section 403(b) Annuities. Insurers, in order to meet the January 18, 1985, effective date of existing Section 72(s), amended their contracts to include Section 72(s) distribution rules, filing with all of the states in which they do business to obtain the required approval for that action. It was reasonable for our members to assume that the distribution rules of Section 72(s) were what were required since 403(b) annuity contracts are not part of qualified plans and the general intent of Congress in enacting Section 72(s) was to require that annuity contracts incorporate qualified plan-like distribution rules. The distribution rules of Section 72(s) are substantially similar to those of Section 401(a)(9), and to require a switch at this point would accomplish little more than impose significant added administrative burdens and expense on our members who complied with what they reasonably thought Congress required last year.

If the proposal to apply the Section 401(a)(9) distribution rules to Section 403(b) annuity contracts is retained, however, we strongly urge that the effective date provision be changed so as to grandfather existing contracts. If the proposal is unchanged, different requirements will apply to contributions made before and after the date of enactment. This split treatment would require either the issuance of new contracts to current participants or the isolation of existing contract values because of the different distribution requirements, necessitating two calculations for each settlement request. Either alternative would impose unnecessary administrative burdens and costs on our members and 403(b) annuity contractholders.

2. State and Local Government Deferred Compensation Plans. It is not clear under existing law whether the distribution rules of Section 72(s) or 401(a)(9) apply to annuity contracts issued in connection with deferred compensation plans meeting the requirements of Section 457. We do not have a view as to which set of rules would be more appropriate, but we do urge that in the interest of certainty and efficiency, one of the two be prescribed as the exclusive set of distribution requirements for such annuity contracts.

C. Exception to the Penalty for Premature Distributions from Annuity Contracts

Proposal:

Subparagraph (B) of Section 72(q)(2) as proposed to be amended by Section 126(c) of H.R. 1800 should be changed to read as follows:

> "(B) made on or after the death of the holder or annuitant."

Reasons for change:

The proposal contained in Section 126(c) of H.R. 1800 would result in a significant substantive change in the law as it has existed since, before the enactment of DEFRA. It would impose a premature distribution penalty tax on annuity contract distributions that are triggered by the death of the annuitant unless the annuitant is also the owner of the contract, or unless a person other than an individual owns the contract and the annuitant is also the primary annuitant. As such, the proposal would work a fundamental change in this Internal Revenue Code provision which is not appropriate for technical correction legislation, particularly since it exceeds the scope of the DEFRA amendment to Section 72(q). (The DEFRA amendment eliminated a distinctly different exception to the penalty relating to investments made within ten years of distribution.)

Moreover, the proposal would penalize legitimate business practice with respect to annuity payments. The death of the annuitant under an annuity contract is frequently an event upon which a contract terminates and a distribution under it is required. It is just as appropriate to except from the premature distribution penalty tax a distribution required under the terms of a contract on the death of an annuitant as a distribution required by law on the death of the holder. In both cases, the distribution is triggered by events outside the control of the holder, and since the triggering event is death it seems quite unlikely to spawn abuses or much tax planning. A distribution under an annuity contract upon the death of the annuitant is not a premature distribution, but rather a distribution precipitated by an event which generally causes the contract to terminate and provide for a distribution. It, therefore, should not be subjected to a penalty as a "premature" distribution.

Finally, the proposed effective date of the amendment is not specified. If the proposed amendment to Section 72(q)(2)(B) is not modified as we recommend, it should not be effective until taxpayers who relied on the TEFRA provision under which the penalty was not applicable on the death of the annuitant have had an opportunity to review their contracts. The proposed change to Section 72(q) is no less significant than the proposed changes to Section 72(s) and therefore a period of at least six months following the enactment of the proposal would appear to be reasonable.

D. Exceptions to the Excise Tax on Certain Funded Welfare Benefit Plans

Proposal:

Section 151(a)(11) of H.R. 1800 would be amended by adding the following underlined language to the amendment to Code Section 4976:

> "(4) EXCEPTION FOR CERTAIN AMOUNTS CHARGED AGAINST EXISTING RESERVE - Subparagraphs (A) and (B) of paragraph (1) shall not apply to post-retirement benefits charged against an existing reserve and any income thereon for post-retirement medical or life insurance benefits (as defined in Section 512(a)(3)(E)."

Reasons for change:

The H.R. 1800 amendment in Section 151(a)(11) provides an exemption from the excise tax provisions of Section 4976 for amounts charged against an existing reserve for post-retirement life insurance or medical benefits. This exemption cross references the unrelated business taxable income provisions in Section 512(a)(3)(E) (as amended by Section 151(a)(10)(C) of H.R. 1800) for the definition of an "existing reserve". For this purpose, an existing reserve for post-retirement life insurance or medical benefits is the amount of assets set aside as of July 18, 1984 for post-retirement life insurance or medical benefits to be provided to covered employees.

A literal interpretation of this amendment provides only partial relief from the excise tax provisions for contributions made on or before July 18, 1984 with respect to post-retirement life insurance or medical reserves. The amendment excludes only an existing reserve, and not the income thereon, from the application of the excise tax. The amendment in referencing "an existing reserve ... as defined in Code Section 512(a)(3)(E)" makes no mention of the income attributable to such an existing reserve and is therefore technically deficient.

The Blue Book provides on page 794 that the rules for the application of the excise tax should be similar to the rules which apply to the analogous provisions with respect to unrelated business taxable income. Both existing reserves and any income thereon are exempt from the unrelated business income tax. See Section 512(a)(3)(E). No policy reason exists to impose an excise tax on the income of an existing reserve while at the same time exempting that same income from the unrelated business income tax.

E. Income Computation for a Failed Life Insurance Contract

Proposal:

In Section 221 of the Deficit Reduction Act of 1984 which adds Section 7702:

> At Section 7702(g)(1)(D)(ii): delete the parenthetical phrase "(computed on the basis of 5-year age brackets)."

Reasons for change:

Section 7702(g)(1)(D) provides that income calculated with respect to a contract which fails the definition of life insurance includes, among other items, the "cost of life insurance protection" based on the lesser of two items: the contract's mortality charge or a cost based on rates prescribed by the Secretary. While a straightforward application of this approach would suggest a direct comparison of the costs determined under the two methods to determine the lesser, this will often produce an inappropriate result. This is because of two facts:

1. The Secretary's rates must (because of the parenthetical expression in Section 7702(g)(1)(D)(ii) be based on 5-year age brackets, presumably reflecting an average assumed cost over the 5-year interval;

2. The overwhelming majority of explicitly stated mortality costs in life insurance contracts are specified for each age, rather than by age brackets.

Thus, for example, if monthly costs are $.35, .37, .40, .43, and .48 for each year of a particular 5-year interval, the Secretary's prescribed rate for that interval might well be $.41. The result then would be the use of $.35, .37, and .40 for the first three years, and $.41 for the last two years.

This clearly erroneous result can be avoided by allowing the Secretary to prescribe a specific rate for each insured age (together with rules for computing average rates over various sized intervals for comparisons with contract rates which are specified for age brackets, if that is also thought appropriate). The 5-year bracket requirement seems to be borrowed from Code Section 79(c); however, in that context no harm is done since no comparisons are made: The prescribed rates are the sole rates used. In this context, it places an unnecessary and inappropriate constraint on the Secretary.

F. Annuities Used to Compensate for Sickness or Injury

Proposal:

Add an exception from the distribution rules of Sections 72(s) and (q) for annuity contracts that are used to fund payments which are excluded from gross income under Section 104(a)(1) or 104(a)(2) of the Code.

Reasons for change:

Annuity contracts are commonly used to fund payments of compensation or damages on account of accident or sickness when the payment is structured to be periodic rather than paid in a lump sum. These arrangements are commonly referred to as structured settlements and involve three parties: (1) a defendant (the person liable for making the payments) or a structured settlement company (a company that assumes the defendant's liability); (2) the insurer (the funding agent); and (3) the injured party (the ultimate recipient of payments funded by the annuity contract). The payments to the injured party are exempt from income tax under Section 104(a)(1) or 104(a)(2) of the Code. Those payments are made either according to a schedule imposed by a settlement of the injury or sickness claim or a court order. That schedule or court order usually varies the amount of payment, for example, to cover medical expenses, and sometimes provides that payments extend beyond the time of death of the injured party.

The defendant or structured settlement company may be subject to the Section 72(q) penalty for annuity payments it receives from the insurer, for example, when the settlement requires payments that vary in amount. We do not think that this situation should be equated with a premature distribution from an annuity contract that Congress sought to penalize when it enacted Section 72(q). In addition, it would be inappropriate to impose a penalty on the defendant or structured settlement company for a payment that would be exempt from the penalty if received directly by the injured party (because of that payment's exclusion from gross income). Finally, Congress recognized the use of annuity contracts to fund structured settlements when it enacted Section 130 (dealing with the taxation of the structured settlement company).

Similarly we urge that structured settlement annuity contracts be exempt from the requirements of Section 72(s). The injured party, the ultimate recipient of payments in a structured settlement, is not taxed on those payments and therefore has no direct tax incentive to seek deferral of payments. Thus, we think that the reason for the required distribution rules do not exist in this situation.

G. Special Rules Where Holder is not an Individual

Proposal:

Subparagraph (6)(A) of Section 72(s) as proposed to be added by Section 126(b)(1) of H.R. 1800 should be changed by adding the following underlined language:

> "(A) IN GENERAL. - For purposes of this subsection, if the holder of a contract is not an individual, or is an individual acting in a representative capacity, the primary annuitant shall be treated as the holder of the contract."

Reason for change:

The effect of the proposed amendment is not clear where the holder is one acting in a representative capacity and the representative is an individual. We believe our suggested addition would further the intent of the Bill by including in the treatment of a primary annuitant as holder, the situation in which an individual holds the contract in a representative capacity such as a custodian or trustee. In such a case, the individual has no beneficial interest in the contract and therefore it would be inappropriate to require a distribution upon his death. Moreover, while the individual may die, the capacity in which he holds the contract (e.g., trustee) does not cease to exist.

H. Exemption of Pre-1985 Accumulations from Penalty on Premature Distributions

Proposal:

In Section 152(a)(2)(A) of H.R. 1800 change the last clause of the paragraph which reads "...clause (i) shall not apply to amounts attributable to contributions paid before January 1, 1985." to read as follows: "...clause (i) shall not apply to amounts attributable to contributions in a defined contribution plan or benefit accruals in a defined benefit plan with regard to plan years beginning before January 1, 1985."

Reasons for change:

In a defined benefit plan it would be particularly difficult and quite arbitrary to relate an amount of a distribution to contributions paid before or after a specific date. We think that since amounts available for distribution in a defined benefit plan are determined by benefit accruals, benefit accruals are a more appropriate and workable measurement for the proposed grandfather treatment. In addition, since benefit accruals generally relate to a plan year rather than a calendar year accounting period, the proposed grandfathering would be more workable if made effective for plan years beginning before January 1, 1985.

Similarly, we think that records kept for defined contribution plans relate contributions, and associated investment performance, to plan year accounting periods. For this reason, we suggest that the effective date for defined contribution plans also be the plan year.

II. COMMENTS ON H.R. 2110, THE RETIREMENT EQUITY ACT TECHNICAL CORRECTIONS ACT

A. Effect of The Retirement Equity Act ("REA") on Single Premium Annuity Contracts

While the ACLI applauds efforts to correct technical problems under REA, we are disturbed that H.R. 2110, the Retirement Equity Act Technical Corrections Act, leaves unaddressed very significant issues regarding terminated plans that were so superficially treated in REA. We think it fair to say that throughout Congressional consideration of REA, there was no contemplation that all of the procedural requirements of that legislation would be extended past plan termination. While we support the basic protections provided plan participants by REA, it has become clear to us since enactment that, when considered in the context of the group annuity arrangements purchased by plan sponsors as part of the process of winding up the affairs of the plan, certain REA provisions impose unnecessary expense and uncertainty on employers and insurers.

Typically, when a plan sponsor of a terminated defined benefit plan winds up the affairs of that plan, it purchases a single premium non-participating group annuity contract ("SPAC"), under which the entire benefit rights of each plan participant are fully guaranteed through an irrevocable commitment issued to the plan participants by a private insurer. Prior to enactment of REA, participants who elected a lump sum payment of their benefits were permitted, under the regulations of the Pension Benefit Guaranty Corporation ("PBGC"), the agency charged with the enforcement of ERISA's plan termination provisions, to irrevocably elect this benefit option and receive an immediate distribution in lieu of the insurer's commitment to provide an annuity at retirement age. This procedure predated purchase of the annuity arrangement and was effectuated by the plan sponsor--not the insurer. In lieu of a cash payment, a participant could elect to be covered by the annuity contract (choosing any of a variety of annuity options) generally determined as of the annuity commencement date and calculated using the insurance company's interest rates and actuarial factors, as specified in the contract negotiated at plan termination between the insurer and the sponsor of the terminating plan. Once a participant elected to receive a commitment to an annuity few, if any, insurers permitted a later election of a lump sum payment.

We recognize that certain of the new requirements imposed by REA necessitate appropriate adjustments in the rules governing plan terminations. So, for example, participant elections in favor of a single life annuity or a lump sum should require spousal consent, even if a plan is terminating. Similarly, elections with respect to benefit options that are made by the participant at the time the plan terminates appropriately should be converted using the interest rates and factors specified in the plan prior to plan termination, as required by Code Section 401(a)(25) and Revenue Ruling 79-90.

Beyond these requirements, however, are a variety of REA imposed procedural requirements which ignore the distinctions between a terminated plan and an ongoing plan. Mandated application of these requirements as the exclusive method of complying with the survivor benefit and anti-cut-back provisions of REA violates the long-held premise of our private pension system that plan establishment and termination are voluntary and that, after plan termination, a participant's rights under an ongoing plan are settled.

While it may be appropriate to protect past accruals in an ongoing plan after a plan amendment, participants in a terminated plan have no expectation of future service or benefit accrual after the date of termination. Accordingly, the ACLI believes there is a clear qualitative distinction between an amendment to an ongoing plan and the termination of a plan. After plan termination, rights which attach to an individual's status as a plan participant are no longer protected. Just as participants are no longer credited with additional vesting and no longer entitled to periodic reports with respect to their benefit rights, summary plan descriptions and the like, it is fundamentally inconsistent with the notion of terminated plans to permit unlimited revocability of benefit elections, additional benefit entitlement based on events occurring after the date of plan termination, and the continuing imposition of the notice and recordkeeping obligations of an ongoing plan sponsor on the insurer.

In the context of plan termination, the insurer is no more than a vendor of a product required under the law to effectuate a plan termination under Title IV of ERISA. The insurer's product is fully regulated under state law, and its obligations to former plan participants derive from the contractual relationships between the individual annuitant and the insurer, rather than from the provisions of the now terminated plan. An employer who decides to establish and maintain an ERISA-covered and tax qualified plan thereby obligates itself to conform to the rules imposed by those statutes. The issuance of a SPAC in satisfaction of a plan's liabilities under Title IV should extinguish the plan administrator's obligations and not, as has been suggested by some since REA, merely transfer his obligations to the insurer of the annuity guarantee. This position is clearly embodied in the Department of Labor's regulations under ERISA defining "employee benefit plan" (29 CFR 2510.3-3) and also in the PBGC regulations defining "participant" for purposes of premium payments (29 CFR 2610.2).

Our detailed comments on specific issues relating to SPAC's where further technical corrections to REA are needed follow below.

1. Treatment of Optional Forms of Benefits. Section 301 of REA amended Section 411(a)(6) of the Code and Section 204(g) of ERISA to provide that a plan amendment which, with respect to benefits attributable to service before the amendment has the effect of eliminating an optional form of benefit, shall be treated as an amendment reducing accrued benefits. The anti-cut-back rules of REA Section 301 further provide that a participant's accrued benefit is only considered to be reduced if the removal of the optional form of benefit results in the participant's loss of a "valuable right". The Secretary of the Treasury is given authority to issue regulations relating to conditions under which the removal of an optional form of benefit will and will not be regarded as the removal of a valuable right.

Under the new statutory rules, optional forms of benefits are treated, for purposes of the anti-cut-back requirements, in some fashion as a participant's accrued benefit. Furthermore, it is possible that regulations ultimately issued will interpret the assumptions, interest rates and conversion factors used by a plan to calculate the amount of a participant's benefit under any particular optional form of benefit as forming part of a participant's accrued benefit which may not be reduced by a plan amendment. Such a position, particularly in the small plan area, would create serious problems for insurers who issue SPAC's to fund a terminated plan. More importantly, this position would, in many instances, increase the costs of terminating plans and ultimately decrease benefits for participants and beneficiaries.

As it is highly likely that an insurer's current internal interest rate assumption for lump sum distributions will be considerably higher than that used by the plan or PBGC, the opportunity is created for adverse selection against the insurer by the participant. Since little or no protection for such adverse selection currently exists, an insurer would be forced to charge a higher price to protect against this risk. Similar results arise in the case of subsidized optional forms of payment where the extent of utilization of the option cannot be reasonable predicted at the time of plan termination.

To resolve this problem, the ACLI suggests that a technical correction to REA be enacted to provide that, upon plan termination, only the participant's initial choice of benefit need be governed by the anti-cut-back in accrued benefit rules. Under this approach, a participant would be given a one-time right to select any optional form of benefit using the plan's assumptions, conversion factors, interest rates and procedures for determining actuarial equivalence. After having made this one-time election, a participant could later choose a different form of payment (limited to those previously available under that plan which provide "valuable rights").

Under the ACLI proposed rule, the insurer would provide the participant with the same alternatives as if the plan had continued. The only exception would be that, for subsequent changes after the initial election by the participant, the insurer's (rather than the plan's) interest rates, conversion factors and procedures for determining actuarial equivalence for optional forms of benefits could be used. This change would allow appropriate distinctions between ongoing and terminated plans and would allow plan amendments in an ongoing plan to be properly subject to the anti-cut-back rules, without encompassing amendments to terminated plans in a way that would make termination more expensive and complicated.

2. Qualified Pre-Retirement Survivor Annuities and Qualified Joint and Survivor Annuities. Another area of substantial concern in our industry relates to the interaction of two promi-

nent sections of REA concerning Qualified Pre-Retirement Survivor Annuities ("QPSA's").

Section 203 of REA provides for the furnishing of a QPSA -- an annuity to a surviving spouse equivalent to 50% of the participant's accrued benefit. At the same time, REA Section 301 prohibits a cut-back in accrued benefits, and treats certain cut-backs in early retirement benefits, retirement-type subsidies and optional benefit forms, as cut-backs in accrued benefits.

Prior to the passage of REA, it seemed clear that a pre-retirement death benefit was not part of the accrued benefit nor was it treated as such. This position was embodied in the Internal Revenue Code Section 411 regulations, which excepted death benefits from the definition of "accrued benefits" (Treasury Regulation Section 1.411(a)-7(a)(1)).

Section 301 of REA does not mention survivor benefits as a type of benefit to be treated as an accrued benefit. On the contrary, the legislative history expressly states that death benefits are not to be considered as a "retirement-type subsidy" under Section 301 such that the anti-cut-back provision would be applicable (See Cong. Rec. of Aug. 2, 1984 - S9679 and S9680.)

In light of this fact, the ACLI believes the QPSA to be outside the scope of the anti-cut-back rules. However, in the event this position is not adopted, we believe the survival of the QPSA is only workable if there is a clear definition of who is the "surviving spouse" in the case of a terminated plan for purposes of REA survivor benefits and the spousal consents necessary to the waiver of any such benefits.

The treatment of this problem by the Technical Corrections Act (H.R. 2110) in an analogous area--that of plan loans--is instructive. In the plan loan area, where the pledging of an accrued benefit as collateral may well have an impact in the future--and a negative impact on a different spouse--H.R. 2110 recognizes that spousal consent to the pledge at the time of the loan will control the impact in the future even if there is a different spouse at that time.

The ACLI suggests that those considerations which are inherent in the above noted loan provision proposal may well be even more pertinent in the area of plan termination. We also suggest that the protection of the individual who is the spouse as of plan termination--despite subsequent occurrences--is not inconsistent with, and may be in furtherance of, the policies underlying REA. It is, after all, the "termination date" spouse who has shared in the marital partnership with the plan participant during the years of benefit accrual.

With regard to plan termination, spousal consent is a particularly troublesome problem by virtue of Internal Revenue Code Section 417, as added by Section 203 of REA, which states that a plan must provide a Qualified Joint and Survivor Annuity ("QJ&S") to a married participant unless such participant waives that benefit with the consent of his or her spouse.

In the case of the QPSA, the election period which would require spousal consent extends to the participant's death. In the case of the QJ&S, that election period (together with the necessity of spousal consent) begins 90 days prior to and ends with the annuity starting date (the date as of which the payments under the plan commence).

Internal Revenue Code Section 417 (a)(2)(B) states that "... Any consent of a spouse (or establishment that the consent of a spouse may not be obtained) under the preceding sentence shall be effective only with respect to such spouse."

In the context of an ongoing plan where the relationship among the respective participants, plan sponsor and plan administrator is normally subject to adjustments (particularly in the area of marital status) there is perhaps less concern regarding these matters.

The difficulty arises, however, when the plan has terminated and (perhaps) the plan sponsor is no longer in existence. The plan has sought a guarantee of its obligations through purchase of annuity contracts or certificates but to a large extent the guarantee is imposed upon what may be a fluid situation.

Thus, a variety of questions arise in the area of plan termination, survivor benefits and spousal consents concerning the timing of events, for example:

o If the plan has terminated and the participant is single at the time, would a subsequent marriage necessitate a spousal consent to the form of benefit chosen? In the absence of such consent, would the benefit need to be converted into a QJ&S? What if the benefit has been distributed and has been partially or fully utilized?

o If the participant, single at plan termination but subsequently married, dies prior to the annuity starting date, would a QPSA have to be provided for the spouse?

o Again, in the context of a terminated plan, assume a participant is married and a QJ&S is provided for, would subsequent divorce negate that survivor benefit?

o If that participant remarries, which spouse is entitled to the survivor benefits?

o If the prior spouse had consented to an alternate form of benefit, does that consent have any impact on the subsequent spouse?

The law would seem to say that in all these circumstances events subsequent to the plan termination may still have to be accounted for. The ACLI believes, however, that such a rule places the insurer in an untenable situation.

The purpose of a plan buying annuities is to provide guarantees and certainty with respect to its obligations accrued to the date of the plan's termination. We suggest that it would be in furtherance of that policy which requires such guarantees and in furtherance of the underlying policies of REA if, for purposes of IRC Section 417, the surviving spouse is defined as the spouse as of the date of plan termination for purposes of the provisions relating to survivor benefits and the notices and consents pursuant to those benefits.

3. Notice Requirements As amended by REA, ERISA Section 205(c) and IRC Section 417(a)(3) require plans to provide participants with written notice of the requirements of a QJ&S and the rights and elections associated therewith, including the requirement that a spouse's consent is needed to waive the joint and survivor benefit. This notice must be provided within a reason-

able period of time before the annuity starting date. Similarly, an explanation of the QPSA must be provided to each participant sometime during the period when the participant is between ages 32 and 35.

ERISA Section 205(c)(6) and IRC Section 417(a)(5) provide that, for separated participants, the applicable election period for the QPSA cannot begin later than separation from service. Although the notice requirement contained in ERISA Section 205(c)(3)(B) and IRC Section 417(a)(3)(B) does not explicitly explain when notice should be given for terminated employees, because notice should precede the election period it would appear that in such cases notice would be given between ages 32 and 35, but not later than separation from service.

These provisions cause serious administrative problems for insurers issuing SPAC's to terminated plans. After plans have been terminated it is very difficult for an insurer to properly give notice to covered employees. In the case of an ongoing plan, the nexus of employment enables the plan administrator to keep accurate and current records of the marital status, age and work status of covered employees. An insurer, by contrast, is not in a position to do so. The problem is severe where the termination is accompanied by the employer's closing of operations. In such a situation the insurer has no one to turn to to ascertain the location and the marital status of the participant. The problem is also acute where participants are still employed by the plan sponsor after plan termination. Because the insurer is not in a position to know when an employee severs employment, it can hardly know when to provide notice for the qualified pre-retirement benefit.

The ACLI proposes that in the case of terminated plans notice should be given to employees at the time of plan termination. In our view this would be both an easy and equitable solution to the above-described problem. At the time of plan termination the employee population is well defined. Furthermore, at that time there is always a plan administrator (independent of whether the employer plans to continue operations) from whom the insurer can get the information which it needs to properly provide notice. Significantly, the purpose of REA would not be compromised under the proposal. At the time of termination, employees are most alert to their rights under a plan and a notice would therefore have its most meaningful impact.

4. IRC Section 411(d)(6), ERISA Title I Section 204(g) and ERISA Title IV. REA prohibits amendments which cause cutbacks in accrued benefits, subsidies, early retirement benefits or optional forms of benefits. Neither the Code nor the parallel ERISA Title I provision deals with termination of a plan.

To avoid the possibility of regulatory duplication and conflict, we propose an amendment to both Code Section 411(d)(6) and ERISA Section 204(g) which would state that nothing therein affects the rules and principles established in ERISA Title IV and PBGC regulations for terminated plans.

As the statutes now read, Title IV continues to be supreme in the plan termination area. Since the enactment of ERISA, Title I and the Code have both prohibited the cutback of accrued benefits. Despite the fact that neither statute provided an exception for terminated plans, accrued benefits have been routinely reduced in terminating plans with assets sufficient to cover guaranteed benefits but insufficient for all benefits. In these cases, assets have been allocated and benefits distributed by guaranteed annuity certificates in accordance with PBGC rules and practice. There is nothing in the statutes themselves after REA to change this. Only the Senate Finance Committee Report suggests a change (S. Rep. No. 98-575, p. 31 (1984)).

It is our view that the question of the benefits to be provided by a terminated plan should be resolved exclusively under the provisions and principles of Title IV--the only Federal statutory scheme dedicated solely to plan terminations. Title IV deals comprehensively with all the issues surrounding the plan termination event including the priorities in which benefits are to be provided and the conditions to be continued post-termination. Purporting to extend Section 411(d)(6) to provide authority for creating asset allocation and benefit priority rules and post-termination procedures will create confusion, conflict and uncertainty through unnecessary regulatory duplication and in certain cases will result in reduced accrued benefit coverage. A technical correction such as we propose would provide a single clear consistent rule for plan terminations--the rules developed under Title IV of ERISA.

5. Retirement-Type Subsidies. Section 301 of REA amended Code Section 411(d)(6)(B) and Section 204(g) of ERISA to provide that a plan amendment that has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy with respect to benefits attributable to service before the amendment is treated as a prohibited reduction in the participant's accrued benefit. In the case of retirement-type subsidies, this prohibition applies only with respect to a participant who satisfies (either before or after the amendment) the pre-amendment conditions for the subsidy. Moreover, Rev. Rul. 85-6 (IRB 1985-5, p.10) provides that in a proposed termination of a defined benefit pension plan, the plan will fail to meet the requirements of Code Section 411(d)(6) as amended unless an early retirement subsidy is provided for participants who satisfy the

pre-termination subsidy requirements after the termination of the plan.

In the case of a terminated plan, the insurer who issues a SPAC must make assumptions as to the number of plan participants who have not satisfied the conditions for the subsidy prior to termination of the plan but will eventually qualify for the subsidy after the plan terminates. Since the risk is uncertain the insurer must use a conservative (and costly) assumption to price the SPAC. This makes the price of a SPAC more expensive than if eligibility for the subsidy were more certain at the time of plan termination. Moreover, the insurer is often required to do costly administrative work to determine who becomes eligible for the subsidy and when that occurs. While it is possible that in many cases, such as the one described in Rev. Rul. 85-6, an employee can satisfy the conditions for the subsidy after termination of the plan, it is also true that in many cases the conditions for eligibility for the subsidy can never be satisfied after the plan terminates. For example, a plan may provide that to be eligible for the subsidy an employee must complete a certain number of years of plan participation (in addition to meeting an age requirement). In such cases, an employee cannot receive credit for additional years of plan participation in any year following the year of plan termination. Similarly, a contributory plan may require a certain number of years of service (in addition to the attainment of a specified age) to be eligible for the subsidy. Under these plans, employees do not get credit for years of service unless they contribute to the plan. Since no contributions are made to a terminated plan, no additional years of service are earned by employees. Finally, under certain conditions employees would not be able to satisfy a service requirement after the termination of a plan if the employer who previously maintained the terminated plan was no longer in existence (due to a sale, spin-off, acquisition, bankruptcy, etc).

To resolve this problem, the ACLI proposes a technical correction to REA to provide that retirement-type subsidies must be provided to employees who have not satisfied the conditions for the subsidy prior to plan termination only if it is possible under the terms of the plan immediately prior to plan termination to satisfy the conditions for the subsidy after the plan terminates.

B. Other Comments

Our section by section comments on areas where we believe H.R. 2110 (the "Act") needs further clarification or correction follow below:

1. Act Section 2(a)(1)(A) - We suggest that the change to paragraph (4) of Section 411(d) be modified by the addition of the words "as an employee" so that it reads "...participant was performing services for the employer as an employee as of the close...." This change would explicitly distinguish employees from independent contractors who are not eligible for benefits or credit under this method.

2. Act Section 2(b)(2)(A&B)(i) - It is our understanding that Code Section 401(a)(11)(B)(iii)(III) will not be triggered by a rollover since, in order for a participant to have received a distribution which he or she can roll over, the joint and survivor requirements would already have had to have been satisfied by the plan making the distribution. In light of this, we believe the reference to "indirect transfers" in Act Section 2(b)(2) should be deleted, since this language would seem to apply only to rollovers. In this way, the provision would only cover a direct trustee-to-trustee transfer.

3. Act Section 2(b)(2)(A&B)(ii) - We suggest that this provision, clarifying transferee plan rules, be modified to read "...if the plan separately accounts

for these assets and any income therefrom." In our view, a plan should be able to set up a segregated account for transferred assets only, but not have segregated accounts for other assets and still satisfy the purposes of this paragraph.

4. Act Section 2(b)(4) - Under this section of the Act, a spouse must agree in writing to a loan to the participant if any part of the account balance is pledged as security. Only if such consent is obtained may the plan foreclose on a defaulted loan. The effective date of this provision is April 18, 1985.

   Obviously, April 18 has already passed and loans are still being negotiated under the requirements of existing law. Accordingly, we believe the effective date of this provision should be changed to the date of enactment.

   In addition, we assume that the requirements for spousal consent under this loan provision are the same as for spousal consent to an election under Code Section 417(a)(2). If this is the case, we suggest that this be explicitly stated in the statute.

5. Act Section 2(c)(4)(A)(v) - While the change to add subparagraph (A) to Code Section 414(p)(9) is necessary, the limitation in subparagraph (B) to the present value of payments to an alternate payee of $3,500 creates a real problem and should be eliminated.

First, the $3,500 amount is, in our opinion, too low. Under Code Section 414(p)(4), an order may require a distribution significantly in excess of $3,500 before a participant has separated from service.

Moreover, using the entire value of the accrued benefit as the appropriate limit is inconsistent with the provisions of Code Section 411(a)(7), which provides that "the plan may disregard service performed by the employee with respect to which he has received (i) a distribution of the present value of his entire nonforfeitable benefit if such distribution was in an amount (not more than $3,500) permitted under regulations...." If the change in Section 401(a)(11) was not deliberate, a suggested clarification is to insert the word "nonforfeitable" following "If the present value of any". If this change was intended, inserting the words "the nonforfeitable portion of" following "$3,500," would clarify the provision.

In this regard, we note that a similar ambiguity exists in Code Section 417(e)(1) and (2)(A). To eliminate any question, in both cases the words "nonforfeitable portion of the" should be inserted before the words "present value" the first place it appears.

6. Act Section 2(d)(1) - The change in the rules for the explanation of a distribution eligible for rollover treatment should not be made retroactively effective (as is the case by virtue of Act Section 3). Such retroactive application in our view unfairly creates a compliance requirement which no one could reasonably have foreseen. We suggest instead that this change be made effective as of the date which is no less than six months after the date of enactment.

7. Act Section 2(f)(1) - While this retroactive protection against a double death benefit liability is very welcome, it seems unfortunate that it must be limited to the period before the plan year beginning in 1985. As a practical matter, there are numerous plans relying on old prototype documents or which, for various reasons, will be slow to comply with these new requirements until the first death under the plan occurs. There seems to be no good reason why this pro-

vision could not be redrafted to apply on a permanent basis to any situation where the pre-retirement survivor annuity requirements are in effect. Such a change would not lessen protection for the spouse and it could significantly improve the chance of the plan being able to provide benefits to the remaining participants.

C. Additional Items

In addition to the corrections noted above, the ACLI believes that several additional items should be added to H.R. 2110 to clarify Congressional intent regarding the changes made by REA. These additions are as follows:

1. Clarification of Code Section 417(c)(2). REA Sections 103 and 203, amending Code Section 401(a)(11) and adding Code Section 417, should be changed to clarify Section 417(c)(2), the "Special Rule for Defined Contribution Plans". Currently, it is unclear whether 50% of a participant's account balance is a minimum to be applied to provide the qualified pre-retirement survivor annuity as otherwise determined by Section 417(c)(1), or if paragraph (2) applies in lieu of paragraph (1). Since applying only 50% of a

participant's account (both vested and non-vested amounts) could result in a lesser death benefit for a spouse than would have been required before REA, there can be a significant difference between the two interpretations.

2. Clarification of Code Section 417(f)(2). REA Sections 103 and 203, adding Code Section 417, should be changed to clarify Section 417(f)(2), which is the definition of annuity starting date. This paragraph provides: "The term 'annuity starting date' means the first day of the first period for which an amount is received as an annuity (whether by reason of retirement or disability)." Based on a literal reading of Section 417(f)(2) it is possible that, for participants who would receive lump sum payments, certain requirements of Section 417 might not be met because no "annuity" payment is made. A suggestion to prevent this is to add the words "or could be" following "for which an amount is". This change would also clarify the beginning date of the qualified joint and survivor benefit election period by effectively starting the election period 90 days before the earliest retirement age.

3. Modification of Code Section 417(a)(3)(B). Code Section 417(a)(3)(B) should be modified by deleting the words "preceding the plan year". As revised, subparagraph (B) would read: "Each plan shall provide to each participant, within the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35...." This would permit the notice and election procedure to occur at the same time, which would be administratively simpler and make it more likely that the participant would act upon the information provided.

4. Clarification of Code Section 411(a)(7). A change should be made to Code Section 411(a)(7) to clarify the status of a participant who separates from service without any nonforfeitable interest in the plan. Currently, it appears possible that unless there is an explicit cash-out, the forfeited funds associated with that participant cannot be made available to reduce employer costs. Yet, with a zero percent vested employee, no cash-out is possible--since nothing is owing to that individual by the plan.

To resolve this potential problem, we suggest that Code Section 411(a)(7) be modified to provide that a participant who separates from service with no vested interest would be deemed to have received a cash-out and his or her accrued benefit can be forfeited. Under this rule, the participant will suffer no detriment so long as: 1) the plan is required to restore the forfeited amount if the participant is re-employed; and 2) the participant would have been able to additionally vest in the accrued benefit had he or she actually received a cash-out and repaid that cash-out upon such re-employment.

Another problem with this same section involves the right of a participant who has received a cash-out of his or her accrued benefit to have a forfeiture restored upon repayment of the cash-out. Prior to REA, Reg. Section 1.411(a)-7(d)(2)(ii)(D) provided that the right of repayment expired two years after the date of re-employment. To prevent any potential record-keeping and funding problems, we suggest that a provision be added to the Act to clarify that the pre-REA two year rule continues to apply to post-REA cash-outs.

5. Clarification of Code Section 411(a)(11). A provision should be added to the Act to clarify how to determine the present value of an accrued benefit for purposes of the Section 411(a)(11) restriction on mandatory distributions. Currently, subparagraph (B) of Section 411(a)(11) provides, in essence, that to determine the amount of present value to test against the $3,500 threshold, the interest rate used may not be greater than the rate used by PBGC for determining the present value of a lump sum distribution at plan termination. The statute is not clear as to whether a plan may test the amount of present value using the PBGC rate, and then recalculate the present value using a different, perhaps higher, interest rate for the actual distribution.

   This ambiguity could be resolved by striking the words "For purposes of subparagraph (A)," and replacing them with the words "Solely for purposes of determining the amount under subparagraph (A),".

6. Form of Annuity. A provision should be added to the Act to clarify that a spouse who is to receive a pre-retirement survivor annuity may elect a form other than a life income.

STATEMENT OF
DONALD C. ALEXANDER
OF CADWALADER, WICKERSHAM & TAFT
before the
COMMITTEE ON FINANCE
UNITED STATES SENATE
On S. 814
May 29, 1985

On behalf of American Financial Corporation, I wish to propose a technical change to S. 814, in order to remedy a serious problem facing life insurance companies which receive dividends from life insurance company subsidiaries. The problem was, we believe, an unintended effect of the changes made to the life insurance company tax provisions in 1984.

Sections 805(a)(4) and 807 of the Internal Revenue Code, as added by DEFRA, require every life insurance company to prorate investment income received by it between the company's share (taxable) and the policyholders' share (excludable from income). The primary effect of this proration is that certain types of income (primarily dividends and tax-exempt interest) which would be tax-favored if received by an entity other than a life insurer receive lesser tax benefits when received by a life insurance company. Some portion of the otherwise tax-favored income must be allocated to the policyholders' share, displacing other income which then becomes fully taxable as part of the company's share. In short, as page 588 of the DEFRA Blue Book recognized, the proration formula has "the effect of taxing a portion of these earnings."

An exception to the proration rule was made in the case of subsidiary dividends, except to the extent such dividends arise from nonsubsidiary dividends and tax-exempt interest received by the subsidiary. Congress' theory was that "to the extent [subsidiary dividends] are distributions of fully taxable income, these earnings have already been taxed at the subsidiary level," and should not be taxed again through the operation of the proration formula at the parent level.

The problem arises from the fact that Congress apparently assumed that a subsidiary from which a life Parent received dividends would be a nonlife subsidiary, and therefore that tax-exempt interest and nonsubsidiary dividends received by the subsidiary and passed through to the Parent "have not been taxed within the related group and should be subject to proration." However, if the Subsidiary is itself a life insurance company, some portion of the tax-exempt interest it passes on to its parent has been taxed through application of the proration formula to the subsidiary. Taxing such portion again at the parent level would cause a life insurance business operated through a parent and subsidiary to be taxed at a higher rate than the same business conducted through one company, contrary to Congress' intent to treat businesses conducted through one company the same as those conducted through more than one.

For example, suppose that a subsidiary life insurance company, S, receives $500,000 in tax-exempt interest, which it distributes to its parent, P, also a life insurance company. Sixty percent of such amount is allocated to the policy-holders' share when received by S, causing an increase in S's taxable income of $300,000. The $500,000 in tax-exempt interest is then passed on to P, which also allocates 60% of its income to the policyholders' share. Thus, the distribution produces an increase in P's taxable income of $300,000. Thus, the related group is taxed on $600,000, or 120% of the amount received, although an insurance business carried on through a single entity would have been taxed on only $300,000.

To remedy this problem, the exception to the proration rule for certain subsidiary dividends should be extended to include all dividends received from a life insurance company subsidiary. Congress, having recognized that income taxed once should not be taxed again within a related group, should apply the same principle to exempt such dividends from the proration formula. Attached is an amendment to S. 814 for this purpose.

AMENDMENT TO S. 814

After the words "any dividend" in the second sentence of section 805(a)(4)(C), insert the following:

except a dividend from a life insurance company

WRITTEN STATEMENT OF JAMES ALBERTINE, DIRECTOR OF GOVERNMENT AFFAIRS OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

The American Society of Association Executives ("ASAE") is pleased to have the opportunity to present a written statement for the printed record of the June 5, 1985 hearing of the Committee on Finance, U.S. Senate on S.814, The Technical Corrections Act of 1985, and on necessary technical corrections to the Retirement Equity Act of 1984 ("REA").

ASAE is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005 (202-626-2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of over 11,000 individuals representing more than 6,500 national, state, and local associations. In turn, these business, professional, educational, technical and industrial associations represent an underlying force of more than 55 million people throughout the world. The overwhelming majority of ASAE's member represent tax-exempt organizations, most of which are either tax exempt as trade associations under Section 501(c)(6) of the Internal Revenue Code ("Code") or tax-exempt as educational or charitable organizations under Section 501(c)(3) of the Code. Many of ASAE's member assocciations sponsor qualified retirement plans and voluntary employee beneficiary associations ("VEBAs") and other funded welfare plans for their members and their employees. As a result, ASAE is an interested party to legislative activity in these areas.

This written statement contains comments on the funded welfare plan rules in S.814 that modify Sections 419 and 419A of the Code, with emphasis on the rules on deemed unrelated income, disqualified benefits, the safe harbor limits and the more-than-10-employer exemption. It also contains comments on two topics in REA. First, the cashout rules under Section 411 of the Code, including the appropriate Pension Benefit Guaranty Corporation ("PBGC") interest rate to be used and the purpose for which it is to be used. Second, the minimum survivor annuity rules in Section 417 of the Code, including the pre-age 35 waiver rules and the form of payment restrictions.

I. S.814

The Technical Corrections Act of 1985 addresses certain technical changes in the Deficit Reduction Act of 1984 ("DEFRA"). ASAE believes that certain additional areas of DEFRA should be clarified.

A. Deemed unrelated income on welfare benefit funds -

DEFRA added a new Section 419A(g) to the Code (relating to deemed unrelated income on welfare benefit funds). ASAE is concerned about the application of this rule to association sponsored welfare plans.

There are many welfare plans sponsored by associations which either have never been tax-exempt under Section 501(c)(9) of the Code or upon the issuance of the final regulations will no longer be tax exempt. Code Section 419A(g) together with the General Explanation of the Revenue Provisions of DEFRA prepared by the Staff of the Joint Committee on Taxation (bluebook), at page 792, imply that the unrelated income is taxed to the employer.

Since welfare benefit funds may consist of many employers, it would be difficult to assess income taxation against the employers participating in the plan. In addition, this could result in double taxation because certain trusts would pay income taxes and the participating employer would also pay income taxes on the same income. Therefore, the deemed unrelated income rule should not apply to employers participating in more-than-10-employer VEBAs. If a tax is to be applied, it should apply at the trust level.

Section 151(a)(9) of the bill, which would add a new Section 419A(g)(3) (relating to coordination of the deemed unrelated income tax on an employer with the rules in Section 419 on qualified cost), attempts to avoid double taxation. For the reasons discussed above, this Section should exclude association sponsored funded welfare plans. If the tax on deemed unrelated income is applied at the trust level, this Section would not be applicable to association sponsored funded welfare plans.

B. Disqualified benefits -

Section 151(a)(11) of the bill amends the definition of disqualified benefit in Section 4976(b) of the Code as used for purposes of the excise tax rules on certain funded welfare benefit plans. Section 4976(b)(1)(C) would benefit fund reverting to the benefit of the employer.' ASAE believes that an additional exception to the scope of Section 4976(b)(1)(C) should be provided to clarify that an excise tax will not apply to an experience refund to an employer or a return of a required "run out reserve" i.e., a reserve that must be held for the sole purpose of paying "run out claims" (those claims that are incurred before plan termination but are not paid until after plan termination).

C. Safe harbor limits -

Section 151 of the bill contains amendments to the funded welfare benefit rules in Sections 419 and 419A of the Code. ASAE believes that the safe harbor rules in Section 419A(c)(5) of the Code should be clarified to provide that they do not take into account reserves that must be held for the sole purpose of paying "run out claims" or for reserves that are held solely for the purpose of retroactive premium arrangements. This interpretation is authorized by the bluebook, at page 778, in the discussion about retired life reserves or premium stabilization accounts which provides, "However, it is intended that Treasury regulations may exclude from the application of these rules a fund under which the residual asset value of these reserves would be immaterial." In most, if not all, cases the residual asset value of these reserves would be immaterial in relationship to the size of the fund during its operation. This clarification would enable Treasury, without any additional legislative changes, to interpret the law in this manner when it issues regulations. This exclusion would make the safe harbor limits much more acceptable to most association-sponsored welfare funds.

D. Funded welfare plans -

DEFRA added new Sections 419 and 419A to the Code (relating to funded welfare plans). The Technical Corrections Act of 1985 in Section 151 contains various technical clarifications to the welfare benefit plan rules. ASAE is concerned about an area that although not currently in the Act, is mentioned in the bluebook as an area in which a technical correction may be necessary.

The literal language of Code Section 419A(f)(6), as amended by DEFRA, creates an exception from the requirements of Code Sections 419 and

419A for a welfare benefit fund which is a part of a ten-or-more employer plan, because it states "This subpart shall not apply . . ." (emphasis added). The bluebook, at page 779, provides that this provision does not apply to deductions for contributions to certain ten-or-more employer plans. Further, page 791 of the bluebook states "[t]he limit on the set-aside is intended to apply to more-than-10-employer VEBAs which are exempt from the deduction limitations". The footnote provides that a technical correction may be necessary so that the statute reflects this intent. As ASAE maintained during the legislative process in connection with DEFRA, the limit on the set-aside should not be extended to plans which have more than 10 employers as participating employers in these plans because these funds do not permit an individual employer to control the operation of the VEBA. Therefore, the competition in the marketplace naturally limits the amount of the reserve. Also, if reserves are insufficient, it is very difficult, if not impossible, to assess any insufficiencies against employers who are no longer participating in these programs.

E. Minimum accruals in a top-heavy plan -

Section 152 of the bill contains amendments to the pension plan provisions in the Code. ASAE believes that an additional technical correction should be added to the bill to clarify the application of the minimum benefit rules under Section 416(c) of the Code. This Section requires that a Non-Key Employee in a top-heavy plan receive certain minimum benefit accruals. The Internal Revenue Service appears to be taking the position that in certain circumstances this top-heavy minimum is in addition to the minimum benefit accrual requirements of Section 411(b) of the Code. ASAE recommends that the bill include an amendment to Section 416(c) or Section 411(b) of the Code to clarify that a top-heavy plan that satisfies the minimum benefit rules under Section 416(c) in the aggregate will be considered as satisfying the minimum benefit accrual requirements of Section 411(b) of the Code without being required to accrue benefits in addition to the aggregate minimum benefits.

II. Retirement Equity Act of 1984

ASAE believes that certain areas of REA require clarification.

A. Cashouts -

REA amended Section 411 of the Code (relating to minimum vesting requirements) to add a new Section 411(a)(11). The new Section provides as follows:

> "(11) Restrictions On Certain Mandatory Distributions -
>
> "(A) In General - If the present value of any accrued benefit exceeds $3,500, such benefit shall not be treated as nonforfeitable if the plan provides that the present value of such benefit could be immediately distributed without the consent of the participant.
>
> "(B) Determination Of Present Value - For purposes of subparagraph (A), present value shall be calculated by using an interest rate not greater than the interest rate which would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation for purposes of determining the present value of a lump sum distribution on plan termination."

This provision, in ASAE's view, is unclear as to which PBGC interest rate should be used and for what purposes.

(1) What rate applies -

The PBGC periodically issues a schedule of four interest rates depending on whether an immediate or deferred annuity is to be purchased. There are three deferred interest rates depending on the annuity commencement date of the participant. ASAE understands that many plans have, in the past, used the PBGC immediate annuity rate as the applicable PBGC interest rate in all situations. ASAE also understands that the PBGC would require a lump sum on plan termination to be valued based on the full range of PBGC interest rates. ASAE believes that a technical correction should be made to REA to clarify that the full range of PBGC interest rates is intended to be used for purposes of Code Section 411(a)(11) and other Sections of the Code and ERISA that reference the PBGC interest rate for purposes of the $3,500 cashout rule.

(2) For what purpose is the PBGC interest rate to be applied -

REA appears to limit the use of the PBGC interest rate to determine whether the consent of a participant to a cash-out must be obtained i.e. whether the amount of a benefit exceeds $3,500. However, it has been suggested that REA also requires that the PBGC interest rate should also be used to determine the amount to be paid in a lump sum. ASAE believes this to be an unwarranted reading of REA. ASAE suggests that a technical correction to REA be adopted to clarify that the interest rate specified in a plan may be used to determine the actual amount to be distributed in a lump sum. This clarification is necessary to approve current plan practices and to avoid plans incurring additional costs in paying out lump sums. ASAE recognizes that there should be safeguards in the law to prevent a plan from using an unreasonably high interest rate. This will not affect the vast majority of plans that are using a range of rates, e.g. from 5% to 9%, that are reasonable.

(3) Determination date -

Section 411(a)(11) of the Code, on its face, requires that a lump sum be valued as of the date of distribution for purposes of determining whether the consent of a participant to a cash-out must be obtained. The

Senate Finance Committee Report provides that the PBGC interest rate as of the first day of the plan year in which the distribution occurs may be used throughout the plan year if the plan so provides. ASAE believes that this is an important administrative rule. ASAE recommends that this rule be included as a technical correction to REA.

B. Minimum survivor annuity -

ASAE believes two clarifications in the survivor annuity rules in REA are in order.

(1) Pre-35 waiver of qualified preretirement survivor annuity -

REA requires that a waiver of the qualified preretirement survivor annuity be made during the "applicable election period". This term is defined in Section 417(a)(5)(B) of the Code, generally, as the period beginning on the first day of the plan year in which the participant attains age 35 and ending on the date of the participant's death. A participant's waiver is valid only if the spouse consents. It would appear that an election by a participant before the plan year in which the participant attains age 35 is invalid. Also, it would appear that while a participant must generally be at least 35 years old to waive this statutory death benefit, the spouse need not be 35 years or older to consent to such a waiver. In ASAE's view, it is unfair to prescribe by law that an adult cannot make a knowing and intelligent decision to waive his benefit before he is 35 years old. The consequence of this rule is that many young adults may be required to make a gift of monies received as a qualified preretirement survivor annuity to other members of their family to provide for the security of those family members. Unfortunately, this may result in adverse income and gift tax consequences that could otherwise have been avoided if the participant and his spouse would have been permitted to decide for themselves how the death benefit should be payable. In this regard, ASAE would also suggest that a technical change to REA provide that a waiver of a qualified preretirement survivor annuity (or a qualified joint and survivor annuity) not be treated as a transfer of property for purposes of the gift tax rules under the Code. To avoid unnecessary problems such as this one, ASAE recommends that a technical correction to REA clarify that a waiver by a participant before he reaches age 35 (and the consent of his spouse at any age) is valid. Alternatively, if Congress determines that a permanent election cannot be made before age 35, a participant should be permitted to make a binding election before age 35 and should be required to make another election at age 35. Although, this additional step would create an administrative burden, it will enable adults, who in all other respects are able to make legally effective decisions, to control the disposition of their death benefit entitlement under the plan.

(2) Form of payment of qualified joint and survivor annuity and qualified preretirement survivor annuity -

Code Section 417, added by REA, defines a qualified preretirement survivor annuity as a benefit in a specified amount payable as an annuity i.e. for the remainder of the life of the spouse. This form of benefit may be waived during the applicable election period. REA does not specify whether a participant (with his spouse's consent) or a spouse (upon the participant's death) may elect that the statutory benefit be paid in the form of a lump sum. ASAE believes that it would be in the best interest of the surviving spouse to allow this death benefit to be paid as a lump sum. ASAE recommends that a technical correction to REA so provide.

ASAE would like to express its gratitude to the Committee for the opportunity to submit this written statement.

Statement by

Richard H. Valentine

of Seward & Kissel

on behalf of

Baldwin Securities Corporation

before the

Committee on Finance

U. S. Senate

June 5, 1985

Summary of Testimony by Richard H. Valentine on Behalf of Baldwin Securities Corporation in Support of a Technical Amendment to Section 1071 of the Tax Reform Act of 1984

Description of Baldwin Securities Corporation

Baldwin Securities Corporation ("Baldwin") is a Delaware Corporation with its principal place of business in New York City. It has been registered under the Investment Company Act of 1940 as a diversified closed-end management investment company since 1950 and has approximately 3300 shareholders. Over 50% of Baldwin's shares are held by one family, making it a personal holding company ("PHC") for federal income tax purposes and, therefore, ineligible to be taxed as a regulated investment company ("RIC") before the Tax Reform Act of 1984 (the "Act").

Problem Posed by Section 1071 of the Tax Reform Act of 1984

The Act amended subchapter M of the Internal Revenue Code to permit a PHC to qualify for taxation as a RIC for tax years beginning after December 31, 1982. Basically a PHC is taxed at the corporate level on all of its income, including income it distributes to its shareholders. A RIC is not taxed at the corporate level on the income which it distributes to its shareholders.

To qualify as a RIC, a corporation must, in addition to meeting certain other criteria, (i) file with its Federal income tax return for the taxable year an election to be taxed as a RIC, and (ii) distribute to its shareholders at least 90% of its investment income for the taxable year. The distribution may be made either during the taxable year or in the following year if it is declared before the tax return for the taxable year is filed.

The Act was signed into law on July 18, 1984. Accordingly, a PHC which had filed its tax return before July 18, 1984, (a PHC having a taxable year ending December 31, 1983, would file its return on March 15, 1984) could not have elected RIC status on its return because the Act was not yet law. Furthermore, the PHC may have failed to declare the appropriate dividend prior to filing its return based on its belief that it could not qualify as a RIC for 1983. It is not clear under current law whether these problems can be cured by having the PHC elect RIC status on an amended return and declare the appropriate dividend prior to filing such amended return.

Example Illustrating the Problem

The following example illustrates how the Act may unfairly penalize a corporation which filed a timely return on March 15, 1984, and the need for the requested technical amendment.

Baldwin is a calendar year taxpayer which filed its Federal income tax return for its taxable year ended December 31, 1983, in a timely fashion on March 15, 1984. For 1983, Baldwin could have qualified as a RIC but for the fact that it was a PHC. The Act was signed into law on July 18, 1984. Baldwin, having filed its return on March 15, 1984, could not have elected to be taxed as a RIC because the Act was not law. If Baldwin had applied for an automatic extension of the filing deadline for its 1983 Federal income tax return to September 15, 1984 and filed its return on that date, it could have elected to be taxed as a RIC for 1983 and it could have declared distributions up to September 15, 1984, in order to comply with the 90% distribution test.

Proposed Technical Amendment

A technical amendment to the Act should be enacted which would clarify that a PHC which had already filed its 1983 tax return at the time the Act became law could qualify as a RIC by electing RIC status on an amended return filed for 1983 on or before September 15, 1984 and by declaring the appropriate dividend for 1983 prior to filing such amended return. Such an amendment would be procedural and would not have a substantive effect on the provisions of the Act.

Mr. Chairman, members of the Committee, thank you for this opportunity to present testimony concerning technical corrections to the Tax Reform Act of 1984 (the "Tax Reform Act"). I am Dick Valentine of the New York City law firm of Seward & Kissel and I am testifying today on behalf of Baldwin Securities Corporation ("Baldwin") in favor of a technical amendment to Section 1071 of the Tax Reform Act. Section 1071 removed the prohibition that prevented a personal holding company ("PHC") from being eligible to be taxed as a regulated investment company ("RIC") and made this amendment effective beginning in tax years after December 31, 1982.

Baldwin is a Delaware corporation with its principal place of business in New York City. It has been registered under the Investment Company Act of 1940 as a diversified closed-end management investment company since 1950 and has approximately 3300 shareholders. Over 50% of Baldwin's shares are held by one family, making it a PHC for federal income tax purposes and, therefore, ineligible to be taxed as a RIC before the Tax Reform Act. In order to avoid the penalty tax on PHCs, Baldwin has annually distributed all of its short-term capital gains and income from dividends and interest, exclusive of expenses and taxes, to its shareholders. Baldwin has accumulated its long-term capital gains.

A corporation that has not qualified as a RIC will be taxed at the corporate level on all of its income, including income it distributes to its shareholders. A RIC, on the other hand, is not taxed at the corporate level on income which it distributes to its shareholders. Thus, qualifying as a RIC for income tax purposes is a significant economic benefit.

In order to be eligible to be taxed as a RIC for Federal income tax purposes for a taxable year, a corporation must meet the requirements imposed by Sections 851(a), 851(b) and 852(a) of the Internal Revenue Code of 1954, as amended (the "Code"). Among those requirements are: (1) that the corporation is a registered investment company under the Investment Company Act of 1940; (2) that the corporation file with its Federal income tax return for the taxable year an election to be taxed as a RIC or that such election have been filed for a previous taxable year, and (3) that the corporation distribute for the taxable year 90% of its "investment company taxable income" and 90% of its tax-exempt interest income (the "90% Distribution Test").

A PHC which was a registered investment company under the Investment Company Act of 1940 for its taxable year beginning after December 31, 1982, and which met the other substantive requirements for RIC status for such taxable year, still would not qualify as a RIC unless it made an election to be taxed as a RIC on its Federal income tax return and unless it met the 90%

Distribution Test for such taxable year. Any such corporation which filed its return before July 18, 1984, the date of enactment of the Act (a corporation having a taxable year ending December 31, 1983 would file its tax return by March 15, 1984), could not have made a RIC election on its return because, based on the law which existed at the time the corporation filed its return, a PHC would not qualify as a RIC. Under current law, it is not clear whether an election to be taxed as a RIC could be made by such a corporation on an amended Federal income tax return filed after the date of enactment of the Tax Reform Act.

Furthermore, such a corporation may not be able to meet the 90% Distribution Test since, as a PHC, it probably would have distributed for its taxable year ended prior to the enactment of the Tax Reform Act an amount equal to its "investment company taxable income" less the Federal income taxes attributable thereto.* Such a corporation would be able to meet the 90% Distribution Test if it is permitted to make an additional dividend relating back to such taxable year pursuant to Code Section 855.** However, Code Section 855 requires that the additional dividend be declared prior to the corporation's filing its Federal income tax return for a taxable year (including extensions) and that the corporation elect on its Federal income tax return to have the dividend considered paid during the prior year for purposes of the 90% Distribution Test. If such a corporation had filed its return for a taxable year which began after December 31, 1982 and ended prior to the enactment of the Tax Reform Act it is not clear under current law whether such corporation could qualify as a RIC for 1983 by electing to utilize the Code Section 855 procedure in connection with an amended return filed after the date of enactment of the Tax Reform Act.

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* If Federal income taxes for such taxable year were more than 10% of "investment company taxable income," the 90% Distribution Test would not be met.

** Pursuant to Code Section 855, a RIC is permitted to meet the 90% Distribution Test for a taxable year by paying an additional dividend in the following taxable year provided (i) that the declaration of such additional dividend is made before the due date (including extensions) for filing its tax return for the taxable year and (ii) that an election is made on such tax return designating what portion of such dividend is to be treated as paid in the taxable year.

It is our recommendation that a technical amendment to the Act be adopted as part of H.R.1800 which would expressly permit a PHC which otherwise met the requirements for RIC status with respect to its first taxable year beginning after December 31, 1982 and which had filed its Federal income tax return for such taxable year prior to the enactment of the Tax Reform Act:

(1) to elect to be taxed as a RIC for such taxable year on an amended Federal income tax return filed no later than September 15, 1984, the date to which an automatic extension for filing an income tax return would have been been granted; and

(2) to declare an additional dividend and elect on its amended return pursuant to Code Section 855 to relate that dividend back to such taxable year for purposes of the 90% Distribution Test.

These provisions could be enacted by amending Section 1071(a)(5) of the Tax Reform Act. A proposed amendment is attached to this Statement.

We believe the proposed technical amendment is clearly consistent with the intention of Congress to have the repeal of the PHC prohibition for RICs be effective for taxable years beginning after December 31, 1982. Unless the steps described above could be taken in connection with amended returns the December 31, 1982 effective date set by Congress with respect to the RIC provisions relating to PHC's would be meaningless to certain investment companies which had filed their 1983 return prior to the enactment of the Tax Reform Act.

Our proposed technical amendment eliminates a potential unfairness against certain corporations. For example, Baldwin is a calendar year taxpayer which filed its Federal income tax return for its taxable year ended December 31, 1983 on March 15, 1984. For 1983, Baldwin could have qualified as a RIC but for the fact that it was a PHC. When it filed its return on March 15, 1984 it could not have elected to be taxed as a RIC because the Tax Reform Act was not enacted until July 18, 1984. However, if Baldwin had applied for an automatic extension to file its 1983 Federal income tax return until September 15, 1984, it could have elected to be taxed as a RIC for 1983 and it could have used the Code Section 855 procedure for relating back dividends in order to comply with the 90% Distribution Test merely because the due date of its 1983 Federal income tax return was extended until September 15, 1984. It would appear to us very unfair to penalize a corporation which filed its 1983 Federal income tax return on March 15, 1984 while rewarding a corporation which applied for an extension to file its 1983 Federal income tax return until September 15, 1984.

We do not believe that the proposed amendment will affect other provisions of the Tax Reform Act relating to RICs. The Tax Reform Act, in addition to eliminating the prohibition against PHCs qualifying as RICs, imposed the requirement that a RIC distribute any earnings and profits which it accumulated during those years in which the corporation was not a RIC. The requirement that a RIC distribute its accumulated earnings and profits from non-RIC years does not, however, apply to a corporation which meets all of the other RIC qualification standards for each of its taxable years ending after November 8, 1983. Thus, a calendar year corporation which met the RIC qualification standards for its year ended December 31, 1983, could qualify as a RIC in 1983 and in subsequent years without distributing its accumulated earnings and profits from non-RIC years.

The Tax Reform Act permits certain registered investment companies which could not previously qualify as RICs because they were PHCs and which filed for the automatic extension to September 15, 1984, to file their 1983 tax returns to qualify as RICs for 1983 and for subsequent years without distributing their accumulated earnings and profits. However, a company such as Baldwin which filed a timely 1983 tax return on March 15, 1984 (i.e., before the Tax Reform Act was enacted) and which did not file for the automatic extension to September 15, 1984, might not qualify as a RIC for 1983, and might not be able to qualify as a RIC for subsequent years without distributing its accumulated earnings (consisting of long term capital gains) from non-RIC years.

The rationale for the requirement that a RIC distribute its accumulated earnings and profits from non-RIC years is to prevent certain operating businesses which have accumulated operating profits from being able to sell their operating assets and to then qualify for treatment as RICs without distributing their operating profits. In addition, there was concern that so-called "tax-managed funds" (i.e., investment companies which accumulated large amounts of dividend income without paying corporate tax thereon because of the 85% dividends received deduction) could become RICs without distributing such accumulated dividend income. These concerns do not apply to Baldwin because Baldwin has been a registered investment company since 1950, not an operating company, and has distributed its dividend income every year to avoid the PHC tax penalty. The fact that Baldwin has accumulated long term capital gains should not be relevant because a RIC is permitted under the Code to accumulate long term capital gains without distributing such gains to its shareholders.

We believe there are only a few corporations who face the problem outlined in this statement. The primary reason for this is that there are very few corporations registered under the Investment Company Act of 1940 which are PHC's. It is apparent that Congress intended that such companies be able to qualify as RICs and our proposed technical amendment will carry out this intent. Furthermore, such a technical amendment could avoid unnecessary litigation on this issue.

In conclusion, we believe a technical amendment of the type suggested above clarifies the problem we have raised and promotes the clear intention of the Tax Reform Act provisions relating to repeal of the prohibition on PHC's qualifying as RICs.

Thank you for this opportunity to present our views on S.814. We would be pleased to provide the Committee with any further information it may require to resolve the issues addressed in our Statement.

Written Testimony to the
SENATE FINANCE COMMITTEE
on
The Great Paradox (or the Great Inequity) of the RETIREMENT EQUITY ACT OF 1984 ("REA")
IRC §401 and §417

Mr. Chairman, I appreciate the opportunity to present to the Senate Finance Committee my views concerning The Great Paradox (or The Great Inequity) of the Retirement Equity Act of 1984 (REA). My comments concern both the serious inequities and unnecessary administrative complexities and liabilities imposed by the Retirement Equity Act.

I am a single person with accrued pension benefits. Single people who marry and have accrued pension benefits prior to marriage are subjected to a serious inequity under REA. Married persons with accrued pension benefits also face serious inequities under REA. There are three simple amendments that will eliminate these inequities. I want to share them with you.

I am also a tax attorney who designs and administers pension plans. As a plan administrator who must bear the responsibility for implementing REA, I am concerned at the unnecessary complexity, the serious liability, and additional expense imposed by REA. I want to share with you a very simple way to eliminate the administrative complexity, liability, and most of the expense imposed by the Retirement Equity Act.

New National Policy

In response to perceived inequities, Congress has set as a new national policy that pension benefits henceforth are to be treated as community property belonging equally to both spouses. That was the intent but the language of REA did not clearly express that policy. Further, in correcting the perceived inequities and setting this new policy, Congress has not been careful to recognize and protect the legitimate existing constitutional rights of those persons who earned the pension benefits in the first place. Congress through the spousal consent requirements has achieved an administrative nightmare for pension administrators that is only approached by the recently repealed auto expense recordkeeping requirements.

Inequities and Constitutional Rights

As a single person I am lodging the strongest possible complaint and protest about the hidden reverse inequities enacted in REA by Congress under the guise of Retirement Equity. My complaint also encompasses an injustice that has been placed upon married persons (of both genders) with accrued pension benefits.

The inequities and injustices caused by REA violate the consititutional rights of pension earners (both married and single) to due process and equal protection guaranteed by the the Fourth and Fourteenth Amendments to the Constitution. Both married persons who earn pension benefits and single persons who earn pension benefits prior to marriage are entitled to have these fundamental rights protected. Both groups have been deprived of property (control over their earned pension benefits) without due process and are now being denied equal protection under the law.

Inequities against Married Persons

Married persons who have earned accrued pension benefits are being deprived of absolute control of not 50% but 100% of their pension benefits. They should have absolute control over at least 50% of the pension benefits they have earned. Under REA spousal consent requirements apply to 100% of accrued benefits in several instances.

Example: Under REA, upon retirement the person earning a pension cannot, without spouse's written permission, leave 50% of his/her own pension benefits directly to children. That is wrong.

Inequities against Single Persons

Single persons who earn accrued pension benefits prior to marriage face a second and greater inequity should they marry. They are being deprived of control over 100% of their pension benefits earned prior to marriage. They should have absolute control over these premarriage pension benefits.

Example: I am single. For over 12 years I have accrued pension benefits in my Profit Sharing and Pension Plans. Under REA, after 1 year of marriage, my wife will have an automatic right to receive at least 50% of my pension benefits accrued before marriage and will effectively control the disposition of 100% of these premarriage benefits. That is wrong.

Today I simply ask this Committee to recognize that these constitutional rights apply to pension earners (married and single) and to restore these constitutional rights by amending the Retirement Equity Act of 1984. My recommended amendment is simple and is set out here in full and in Appendix A.

REA Technical Corrections Act (HR 2110)
Recommended Addition to IRC §417

"(g) Limitation on Spousal Consent Requirement

(1) 50% Limitation. Spousal consent shall not be required under any circumstance for more than 50% of a participant's accrued benefit.

(2) Premarriage Accrued Benefits. This section (IRC §417) shall not apply to, nor shall spousal consent be required under any circumstance for, employee benefits accrued prior to the participant's marriage.

(3) Loans. Spousal consent shall not be required on loans which are less than the greater of $10,000 or 50% of the participant's accrued benefits."

As you can see, the proposed changes are simple, they

1) Clarify Congressional intent to exempt 50% of accrued benefits from spousal consent requirements

2) Exempt 100% of premarriage accrued benefits from spousal consent requirements, and

3) Exempt loans which are less than the greater of $10,000 or 50% of accrued benefits from spousal consent requirements. This last proposal corrects a similar problem presented in the proposed REA Technical Correction Act (HR 2110).

I ask that you seriously consider these admendments. They will carry out Congressional intent and eliminate the current inequities in REA. For further reasons in support of these changes please see Appendix B to this report.

Administrative Complexity

As a tax attorney and pension plan administrator I strongly protest the avoidable administrative complexity which REA imposes. I particularly protest the increased liability that I must now assume as an administrator to carry out these Congressional mandates.

If Congress really did intend "that spousal consent should not be required for more that 50% of a participant's accrued benefit," then Congress is only one short conceptual step from being able to to greatly simplify the greatest problem with REA (i.e. administrative complexity and the resulting administrator's liability).

Two proposed alternatives merit your serious consideration. The first alternative all but eliminates the administrative complexity imposed by REA. The second alternative minimizes it.

The first alternative requires that Congress go one step further and give to the nonearning spouse the 50% of accrued benefits over which spousal consent is required. This step would eliminate most administrative requirements and all administrative liabilities. As a plan participant I would rather give 50% of my postmarriage accrued benefits away than have problems with a future spouse. As an administrator, I would rather double the number of plan participants than have to deal with REA's complex administrative requirements and resulting liabilities caused by the spousal consent requirements.

A second alternative would minimize administrative complexity and record keeping requirements. This alternative would:

1. Require that an IRS approved explanation of Pre-Retirement and Joint and Survivor Annuities be provided to all administrators for distribution to plan members and spouses. This shifts the administrator's liability for incorrect or misleading information to the IRS where it belongs.

2. Require that pre-retirement survivor annuities equal to 50% of benefits, and a Joint and Survivor's Annuity equal to 50% of the benefits be required unless spousal consent is obtained by the plan member. This retains the earning spouse's right to control and leave their 50% to whomever they wish. At the same time it protects the nonearning spouse by giving them control over the other 50%. Further, it solves the original problem Congress intended to correct, it protects the surviving spouse.

3. Place responsibility to explain annuities and obtain spousal consent on the IRS and the spouse seeking the consent. This shifts the responsibility and liabilities back where it belongs (i.e. the IRS and the parties to this mystical union called marriage). The administrator's liability is then limited to timely distribution.

4. Limits the Administrators' responsibilities and liabilities to:

   a. Timely distributing IRS approved information

   b. Following participants' directions received prior to the date of distribution:
      1) If consent filed - follow direction given by spouses
      2) If consent not filed - follow statutory directions

I ask that you seriously consider the first alternative. It will carry out Congressional intent and eliminate both the administrative complexity and resulting administrators' liabilities. The second alternative is a step in the right direction, but would only minimize the inherent complexities and liabilities caused by the spousal consent requirement.

Eliminate Annuity Requirement

Third, as a plan participant I strongly protest the requirement for mandatory insurance annuities which accompanies REA. As a tax attorney and investor the first thing I learned was that annuities are at best a bad investment and at worst a rip-off. Please do not allow this bad investment to continue to be the required pension distribution.

Conclusion

The inequities in the Retirement Equity Act (REA) are real but correctable; the administrative complexity and liability in REA are serious but correctable. As a pension earner, I ask that Congress correct the inequities in REA. As a pension administrator and tax lawyer, I ask that Congress eliminate both the needless complexity and liability now found in REA. Thank you.

RETIREMENT EQUITY ACT

Appendix A
Ralph G. Brodie
June 16, 1985

REA Technical Corrections Act (HR 2110)
Recommended Addition to IRC §417

"(g) Limitation on Spousal Consent Requirement

(1) 50% Limitation. Spousal consent shall not be required for more than 50% of a participant's accrued benefit under any circumstance.

(2) Premarriage Accrued Benefits. Spousal consent shall not be required under any circumstance for employee benefits accruing prior to the participant's marriage.

(3) Loans. Spousal consent shall not be required on loans which are less than the greater of $10,000 or 50% of the participant's accrued benefits."

Appendix B
Ralph G. Brodie
June 16, 1985

Explanation of Recommended Additions to IRC §417

1. Clarification That REA Spousal Consent Requirement Applies Only to 50% of Accrued Pension Benefits

2. Proposed Use of Prenuptial Agreement to Protect Pension Benefits Accrued Prior to Marriage.

3. Exemption of Pension Benefits Accrued Prior to Marriage from Spousal Consent Requirements.

4. Exemption of Loans from Spousal Consent Requirement. Technical Correction (H.R. 2110) Section 2(b)(4) Which Adds IRC §417(a)(1)(c) and §417(f)(5)

1. Clarification that REA Spousal Consent Requirement Applies Only to 50% of Accrued Pension Benefits

I understand that presently an effort is being made to clarify the congressional intent for REA by having legislative history clearly state that "spousal consent shall not be required for more than 50% of a participant's accrued benefit." Further, I understand that the IRS is proposing regulations that will also reflect this legislative intent.

While this is a step in the right direction, specific statutory clarification of this issue is needed and is the only remedy guaranteed to protect this fundamental property right. As a beneficiary of this clarification, I think the issue is so important that I want a statutory amendment to provide this needed clarification and protection.

The reason I feel so strongly about the need for specific statutory changes is that IRC §417(c)(2) Special Rule for Qualified Preretirement Survivor Annuity for Defined Contribution Plans requires a preretirement survivor annuity "which is not less than 50 percent of the account balance of the participant as of the date of death."

Under normal statutory construction, I believe that this language poses a strong argument that is more than sufficient to negate reams of legislative history and IRS regulations to the contrary, i.e. Congress, in specific legislation internal to REA itself clearly stated a 50% limitation once for preretirement survivor benefits, therefore Congress, by not specifically including the 50% limitation for other areas in REA, purposefully intended to apply spousal consent requirements to 100% of the accrued benefits in all other situations.

I recommend the following addition to IRC §417. New Subsection (g) would state as follows:

> "(g) Limitation on Spousal Consent Requirement
>
> (1) 50% Limitation. Spousal consent shall not be required under any circumstance for more than 50% of a participant's accrued benefit.

This first recommendation is made even though I have come to the conclusion that the whole concept of requiring spousal consent concerning employee benefits is both fundamentally and constitutionally wrong. I believe that if Congress voted to make separately owned stocks, bonds, real estate, etc. subject to the same spousal consent requirements, the public would throw them out of office for violating their constitutionally protected right to individual property ownership. Pension rights are individual property rights too, and should enjoy the same constitutional protection.

2. Proposed use of Prenuptial Agreement to Protect Pension Benefits Accrued Prior to Marriage.

I understand that you share my concern over subjecting premarriage pension benefits to spousal consent. I also understand that the women's groups who lobbied against exempting premarriage pension benefits countered by citing the fact that in community property states that non-designated premarriage property became part of the community property. [This is not true in common law states, however.] I also understand that because of the power of these women's groups that many people feel that it is not likely that this problem can be changed without a constitutional challenge or strong lobbying effort to overcome it.

I understand that an effort is being made to protect premarriage accrued benefits in other ways such as the proposed use of prenuptial agreements. While recognition that premarriage accrued benefits should be protected is welcomed, the proposed method of relief is illusory at best.

For the life of me I can't see why single people should be required to obtain a prenuptial agreement to protect property rights (the pension benefits that accrued before marriage) that are absolutely theirs to begin with. Besides whose spouse, other than an idiot or a totally dominated spouse (both of whom need protection), would sign away these rights knowingly and voluntarily. Prenuptial agreements will not provide the necessary protection to which this constitutional property right is entitled.

3. Exemption of Pension Benefits Accrued Prior to Marriage from Spousal Consent Requirements

While I am not a constitutional lawyer, I believe that individual pension benefits accrued prior to marriage are constitutionally protected property rights. These rights cannot be taken from a person by Congressional whim and to do otherwise is to violate the constitutional principles of due process and equal protection. This constitutional violation would be clearer still if Congress mandated a similar provision for inherited property or other property an individual owned prior to marriage.

Therefore, I recommend adding new subsection (g)(2) as follows:

> (g) Limitations on Spousal Consent requirement.
> (1) ...
> (2) Premarriage Accrued Benefits. This section (IRC §417) shall not apply to, nor shall spousal consent be required under any circumstance for, employee benefits accrued prior to the participant's marriage.

4. Exemption of Loans from Spousal Consent Requirement. Technical Correction (H.R. 2110) Section 2(b)(4) Which Adds IRC §417(a)(1)(c) and §417(f)(5)

Despite the de minimus nature of extending spousal consent to pension loans, women's groups apparently wanted the extra $5 or $10 per month regardless of the added administrative complexity and extra costs to someone else.

If Congressional intent is being clarified to limit the Spousal Consent to a maximum of 50% of accrued benefits, this problem concerns at the most $10,000. This is OVERKILL at its worst.

I recommend adding new subsection (g)(3) as follows:

"(g) Limitation on Spousal Consent
(1) ...
(2) ...
(3) Loans. Spousal consent shall not be required on loans which are less than the greater of $10,000 or 50% of the participant's accrued benefits."

As you can see, those proposed changes

1) Clarify Congressional intent to exempt 50% of accrued benefits from spousal consent requirements

2) Exempt premarriage accrued benefits from spousal consent requirements

3) Exempt loans which are less than the greater of $10,000 or 50% of accrued benefits from spousal consent requirements.

Stephen B. Bonner
Executive Vice President and
General Counsel

Capital Holding Corporation
680 Fourth Avenue
Post Office Box 32830
Louisville, Kentucky 40232
502 560-2000

Capital Holding

1985 [illegible] 17 [illegible] 14

June 10, 1985

Mr. William Diefenderfer
Chief of Staff
Committee on Finance
United States Senate
Washington, D.C. 20510

RE: S. 814 - Technical Corrections Act

Dear Mr. Diefenderfer:

On behalf of Capital Holding Corporation, we respectfully request that the enclosed statement be made a part of the official record for the June 5, 1985 hearing of the Committee on Finance on S. 814, the Technical Corrections Act of 1985.

Pursuant to the rules of the Committee, we are enclosing five (5) copies of the Capital Holding Corporation statement. If additional information is needed, please do not hesitate to call.

Sincerely,

Stephen B Bonner

SBB:sy

Enclosures

May 29, 1985

TREATMENT OF CERTAIN DEBT INSTRUMENT PURCHASES AS LOANS UNDER SECTION 815

The proposed Technical Corrections Act of 1985 (introduced as H.R. 1800 and S. 814) would amend section 815 of the Code to clarify that a bona fide loan cannot constitute a distribution within the meaning of that provision. This amendment is necessary because of the facts recounted below, and, as will be explained, it is also necessary to extend its scope to cover purchases of mandatorily redeemable preferred stock.

Under section 815 of the Code as revised by the Tax Reform Act of 1984, distributions to the shareholders of a stock life insurance company are considered to be made from the company's "shareholders surplus account" (with no immediate tax consequence to the company) or from its "policyholders surplus account" (triggering the so-called phase III tax) whether those distributions are made in the form of direct payments or in a more indirect form. This generally preserves, and yet expands somewhat, the rules of section 815 under prior law. See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1410-1411 (1984): S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 536 (1984); Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 594 (1984) (the "Blue Book").

The direct distributions to which new section 815 refers clearly are those encompassed by the prior law rules, such as the typical corporate dividend and (as former section 815(f) expressly provided) a distribution in redemption of stock. The new statute's reference to indirect distributions, on the other hand, represents an addition to the phase III rules to make it clear that distributions made to others for the benefit of shareholders (as well as those made directly to shareholders) are counted as disbursements from the phase III accounts. An oft-cited example of such an indirect distribution is a subsidiary's purchase of its parent's stock from one of the parent's shareholders, which section 304 of the Code treats as a distribution in redemption of stock. The Tax Court found such a transaction to be a distribution within the meaning of former section 815 in Union Bankers Insurance Company v. Commissioner, 64 T.C. 807 (1975). As the committee reports accompanying the 1984 Act explained:

> "The bill provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of the distribution. For these purposes, the term distribution is intended to include actual and constructive distributions. See Union Bankers Insurance Co. . . . ."

H.R. Rep. No. 432, supra; S. Prt. No. 169, supra.

The Blue Book, however, went considerably beyond this in its commentary on indirect distributions under new section 815:

> "The citation to Union Bankers Insurance Co. indicates the type of fact situations in which liability for a phase III tax could arise. . . There would be an indirect distribution [from the policyholders surplus account] . . . whenever policyholders surplus account funds are used to benefit the shareholders indirectly (for example, by having the stock

> life insurance company purchase the parent's stock either from the parent or a shareholder of the parent, or by having the company make loans to the parent whether or not for adequate consideration)."

The Blue Book's reference to inter-corporate loans, and its conclusion that they should be treated as section 815 distributions, had no precedent in the language or legislative history of the 1984 Act, let alone in the provisions or interpretations of the prior law which new section 815 generally preserved. See, e.g., PLR 8033102; PLR 7848006. The same was true of inter-corporate purchases of mandatorily redeemable preferred stock. See, e.g., PLR 8515017 (1984 Act).

While the treatment of purported loans as distributions is understandable where they do not constitute true indebtedness (as where there is no intention to obtain repayment or no compensation for the time value of money), such treatment of bona fide loans is unwarranted. Loans to affiliates that have the characteristics of arms-length indebtedness -- those that are documented, repayable, and compensated in the same manner as borrowing between non-affiliated entities -- constitute legitimate investments of the lending party and, with respect to the borrowing party, provide no benefit akin to an ownership distribution. In case of a life insurance company in particular, it is to be expected that the company (acting in its role as a financial intermediary) will seek to make bona fide loans to earn a return on its financial assets. And it should not be surprising that a company will make such loans to its affiliates, for its own convenience and security as well as that of the affiliated group;

indeed, such loans are commonplace.

Recognizing this, section 121(j) of the proposed Technical Corrections Act would add a new sentence at the end of section 815(a), which would state: "For purposes of the preceding sentence, the term 'indirect distribution' shall not include any bona fide loan with arms-length terms and conditions." The Treasury Department, in its testimony before the Ways and Means Committee at the May 16, 1985 hearing on the proposed Act, indicated its support for this clarifying amendment.

This proposed change, as far as it goes, is entirely meritorious and should be adopted. It should also be extended, however, to bring manditorily redeemable preferred stock within its ambit. Such stock is more closely akin to debt than to equity, and a life insurance company's purchase of such stock issued by an affiliate, like its grant of a bona fide loan to the affiliate, should not give rise to a constructive "indirect distribution" under section 815. This becomes clear when the characteristics of such stock are examined:

> Like a bona fide loan, mandatorily redeemable preferred stock provides its holder with the issuer's unconditional promise to pay a principal sum certain on or before a fixed maturity date.
>
> Like indebtedness, the final payment date is not unreasonably far in the future, typically not beyond 20 or 30 years after the stock was issued.
>
> Unlike equity interests, the stock is typically redeemable by means of a sinking fund arrangement, with ratable redemptions each year beginning on a future date (such as after 5 or 10 years beyond the issue date) and ending with the maturity date.

> Also unlike equity interests generally, the stock does not entitle its holder to voting rights (except for limited rights which only become available under circumstances amounting to default), and it grants the holder no pre-emptive rights to subscribe to future equity issues.

In light of these characteristics, the purchase of mandatorily redeemable preferred stock is, from the perspective of the purchaser, tantamount to the grant of a long-term loan to the stock's issuer. It therefore should be treated, from the standpoint of section 815, in the same manner as a direct loan.

The Internal Revenue Service recently recognized as much in a private ruling issued under the 1984 Act. In that ruling, the Service held that a life insurance company's acquisition of preferred stock of its parent that was mandatorily redeemable (with ratable redemptions, on a sinking fund basis, beginning after 5 years beyond the issue date and continuing for the next 25 years) did not give rise to a distribution under section 815. See PLR 8515017.

To confirm this treatment of mandatorily redeemable preferred stock, the following underscored phrase should be added to the sentence that section 121(j) of the proposed Act would include in section 815(a):

> "For purposes of the preceding sentence, the term 'indirect distribution' shall not include any bona fide loan with arms-length terms and conditions or any transaction which involves the purchase of stock by the life insurance company that is preferred as to dividends and mandatorily redeemable by the issuer."

DOW, LOHNES & ALBERTSON
1255 TWENTY-THIRD STREET
WASHINGTON, D. C. 20037

TELEPHONE (202) 857-2500
TELECOPIER (202) 659-0059
CABLE "DOWLA"
TELEX 425546

WRITER'S DIRECT DIAL NO.

STATEMENT OF WILLIAM SILVERMAN
ON BEHALF OF
THE CANADIAN TUBULAR PRODUCERS ASSOCIATION
ON
THE TECHNICAL CORRECTIONS ACT OF 1985
BEFORE
THE SENATE COMMITTEE ON FINANCE
(June 12, 1985)

Mr. Chairman and members of the Committee, my name is William Silverman. I am a partner at the law firm of Dow, Lohnes and Albertson. This statement is submitted on behalf of the Canadian Tubular Producers Association (the "CTPA") in support of Section 224 of the Technical Corrections Act of 1985 (S. 814), concerning the marking of imported pipes and pipe fittings by stenciling or tagging. The CTPA is a voluntary, private association of Canadian producers of pipes, tubes and pipe fittings.

This document is submitted by Dow, Lohnes and Albertson, which is duly registered under the Foreign Agents Registration Act of 1938, as amended, as an agent of the Canadian Tubular Producers Association.

945 PERIMETER CENTER PARKWAY SUITE 300 ATLANTA, GEORGIA 30346 TELEPHONE (404) 399-2700
TELECOPIER (404) 394-8074 CABLE "DOWATL" TELEX 4995255
80 WEST STREET SUITE 150 ANNAPOLIS, MARYLAND 21401 TELEPHONE (301) 263-0043

In October 1984, Congress adopted Section 207 of the Trade and Tariff Act of 1984. Section 207 requires that imported pipes and pipe fittings be marked with their country of origin by die stamping, cast-in-mold lettering, engraving or etching (the "Statutory Marking Methods"). Although the CTPA does not oppose the marking of pipes and pipe fittings with their country of origin, it believes that Section 207 unintentionally created a nontariff trade barrier because for many types of pipes and pipe fittings, the Statutory Marking Methods would violate industry and customer standards, would be commercially infeasible or would render the pipes and pipe fittings unfit for their intended uses. Consequently, at the urging of the Canadian government, the CTPA, Members of the Committee and the House Ways and Means Committee, their staffs and members of the Administration, the U.S. Customs Service ("Customs") issued interim rules allowing imported pipes and pipe fittings to be stenciled or tagged with their country of origin, instead of having to be marked by the Statutory Marking Methods, while it determined how best to implement Congress's intent in enacting Section 207.

During this interim period, Committee staff members and Customs graciously entertained written and oral presentations by the CTPA and other domestic and foreign interested parties on the types of pipes and pipe fittings that should be exempt from the Statutory Marking Methods and on the permanency of stenciling as an alternative means of marking. As part of its presentation to Customs, the CTPA submitted to Customs on February 13, 1985 a letter describing:

> (1) Certain types of pipes that should be marked with their country of origin by stenciling or (for small-diameter sizes) the tagging of bundles because the Statutory Marking Methods would violate industry/customer standards or would render the pipes unfit for their intended uses;
>
> (2) A study showing that stenciling is more legible and as permanent, if not more so, than die stamping or etching; and
>
> (3) A study showing the corrosive effects that the Statutory Methods of Marking would have on stainless steel and high nickel alloy tubular products.

A copy of that letter, with the above-described studies, is attached hereto as Exhibit I.

Effective May 15, 1985, Customs issued guidelines permitting certain types of pipes and pipe fittings to be marked with their country of origin by stenciling or the tagging of bundles (the "Customs Guidelines"), instead of by the Statutory Marking Methods. Although the Customs Guidelines eliminated much of the problem associated with Section 207, the uncompromising language of Section 207 forced Customs to strictly construe the statute. For example, the Customs Guidelines require that certain types of pipes (such as stainless steel pipe, hollow structural sections, structural pipe and pipe used for roll over protection systems) must be marked by the Statutory Marking Methods despite the fact that this would be commercially infeasible and unacceptable to the ultimate consumer. See, e.g., Letter from Joseph P. Cravero, Senior Tax Attorney, Deere & Company, to the Commissioner of Customs, a copy of which is attached hereto as Exhibit II.

Section 224 of the Technical Corrections Act of 1985 would amend Section 207 to permit alternative methods of marking, such as stenciling or tagging, if it is "technically or commercially infeasible" to mark the pipe or pipe fitting by the Statutory Marking Methods. The amendment clarifies Congress's intent as to the proper administration of Section 207 and reflects Congress's policy that Customs should not require the use of the Statutory Marking Methods if they would adversely affect the product's "structural integrity" or reduce its "commercial utility". Joint Committee on Taxation, Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814), (JCS-7-85), Apr. 14, 1985, at 144.

The CTPA fully supports Section 224 and urges its expeditious enactment. By explicitly recognizing that technical and commercial factors should be considered in determining the most effective method of marking pipes and pipe fittings with their country of origin, Section 224 would eliminate a potential nontariff trade barrier. Upon Section 224's enactment, Customs should immediately initiate a new administrative proceeding to modify the Customs Guidelines to conform with the Congressional intent expressed in Section 224.

It has come to the CTPA's attention that the American Iron and Steel Institute would like Section 224 modified to provide that where stenciling is permitted, it must be continuous stenciling because single-mark stenciling is not as permanent as the Statutory Methods of Marking. This is not correct; single-mark stenciling is as permanent, if not more permanent, than the Statutory Methods of Marking. This is further elaborated upon in the letter we submitted on behalf of the CTPA to George J. Weise, Esq., Professional Staff Member, House Ways and Means Subcommittee on Trade, dated May 15, 1985, a copy of which is attached hereto as Exhibit III.

In conclusion, the CTPA wishes to thank the Committee Members, their staff and Customs for recognizing the inadvertent problems created by Section 207's enactment and for promptly acting to avert what could have been a serious international trade dispute. It is our hope that Section 224 will be quickly enacted into law and that Customs immediately thereafter will initiate administrative proceedings to implement it.

EXHIBIT I

DOW, LOHNES & ALBERTSON
1255 TWENTY-THIRD STREET
WASHINGTON, D. C. 20037

TELEPHONE (202) 857-2500
TELECOPIER (202) 659-0058
CABLE "DOWLA"
TELEX [illegible]

WRITER'S DIRECT DIAL NO.

(202)857-2675

February 13, 1985

Rec'd 2-13-85
U.S. Customs

BY HAND

Commissioner of Customs
Regulations Control Branch
U.S. Customs Service
1301 Constitution Avenue, N.W.
Room 2426
Washington, D.C. 20229

Re: Country of Origin Marking of Pipe and Pipe Fittings of Iron or Steel

Dear Sir:

This letter is submitted to the U.S. Customs Service ("Customs") by the Canadian Tubular Producers Association (the "CTPA") in order to supplement the Government of Canada's January 24, 1985, submission to Customs (the "GOC Submission", a copy of which is attached as Appendix A) commenting upon the new country of origin marking requirements for pipes and pipe fittings, enacted as Section 207 of the Trade and Tariff Act of 1984 ("Section 207"). The CTPA is a voluntary, private association of Canadian producers of pipes, tubes and pipe fittings.

Section 207 requires that pipes and pipe fittings be marked by means of die stamping, cast-in-mold lettering, etching or engraving. Although the CTPA has no objection to the requirement that pipes and pipe fittings be marked with their country of origin, it is our position that:

(1) Customs has the legal authority to authorize alternative methods of marking if Section 207's statutory marking methods would violate

industry standards or would render the pipes or pipe fittings unfit for their intended use.

(2) In determining whether Section 207's four statutory marking methods would render the pipes or pipe fittings "unfit for the purposes for which they were intended or [would violate] industry standards", Customs should include in its consideration whether these methods would violate customer specifications or would be contrary to the customs and usage of the industry.

(3) Pursuant to the above standards, Customs should allow alternative methods of marking (such as stenciling or tagging in bundles) for those pipes and pipe fittings described in the GOC Submission. The GOC's approach, which identifies exempted pipes and pipe fittings by ASTM, API or other specifications, would not create an administrative burden for Customs because such information is already reported on the Special Summary Steel Invoice.

(4) Because of the technical difficulty of immediately complying with any decision issued by Customs on this matter, Customs should provide for a 120-day implementation period before its decision enters into effect and should rule that its decision would not apply to pipes and pipe fittings produced before the end of that period.

I. CUSTOMS HAS THE AUTHORITY TO PRESCRIBE ALTERNATIVE METHODS OF MARKING UNDER CERTAIN CIRCUMSTANCES.

Section 207 amends Section 304 of the Tariff Act of 1930, 19 U.S.C. §1304 (1982), by requiring that imports of "pipes of iron, steel, or stainless steel" be marked with their country of origin "by means of die stamping, cast-in-mold lettering, etching, or engraving." Pub. L. No. 98-573, §207, 98 Stat. 2948, 2976 (1984). The statute's language, however, when analyzed in light of its application to specific products, is sufficiently vague and ambiguous that its mechanical application would impose a substantial hardship on foreign pipe and pipe fitting manufacturers and their American customers and would constitute a significant nontariff trade barrier in violation of the United States' international obligations.

Congress has provided Customs with authority to issue regulations in general and with specific authority to issue regulations in particular on country of origin marking. See 19 U.S.C. §§1304(a)(1), 1624 (1982). See also 19 U.S.C. §§66, 1202 (Headnote 11) (1982). This authority is sufficiently broad enough to permit Customs to promulgate rules interpreting and implementing Section 207's requirements. In addition, Senator Danforth in his pre-enactment floor statement on Section 207 specifically said that the Senate "would expect the Secretary of the Treasury to prescribe a reasonable method of marking under section 304(a)(1) that does not preclude imported pipe and fittings from meeting industry technical specifications, such as those of the American Petroleum Institute." 130 Cong. Rec. S13,971 (daily ed. Oct. 9, 1984). Finally, in a letter to Canadian Member of Parliament Maurice Foster (a copy of which is attached as Appendix B), Senator Mattingly, Section 207's Senate sponsor, stated that, "It is my hope that this [Section 207 marking] issue can, and will, be resolved administratively by the U.S. Customs Service."

Therefore, Customs' proposal to permit alternative methods of marking under certain circumstances is within its regulatory authority. These alternative methods (described below) would fulfill Section 207's statutory purpose of indicating to the ultimate purchaser the country of origin of imported pipes and pipe fittings. In fact, in many cases, the alternative methods of marking would be a more permanent and visible method of marking than Section 207's marking methods.

II. CUSTOMS SHOULD CONSTRUE ITS STANDARDS FOR ALLOWING ALTERNATIVE MARKING METHODS TO INCLUDE CUSTOMER SPECIFICATIONS AND INDUSTRY CUSTOMS AND USAGE.

The CTPA does not oppose the marking of pipes and pipe fittings with their country of origin. Nevertheless, as correctly noted in Customs' January 9, 1985, Federal Register request for comments on this issue, Section 207's marking requirements should be read in conjunction with Section 304 of the Tariff Act of 1930, as amended. 50 Fed. Reg. 1064, 1065 (1985). Section 304 provides that, in general, imports should be permanently marked with their country of origin "as the nature of the article or its container will permit." 19 U.S.C. §1304 (1982).

In its request for comments, Customs reconciled the provisions of Sections 207 and 304 and Senator Danforth's floor statement by proposing that pipes and pipe fittings be marked by alternative methods of marking (such as stenciling or tagging in bundles) if Section 207's marking methods would render such pipes and pipe fittings "unfit for the purposes for which they were intended or [would violate] industry standards for such articles." 50 Fed. Reg. at 1065. The CTPA agrees with this standard so long as Customs construes it to include (1) individual customer specifications, and (2) industry customs and usage.

Customs should not interpret the phrase "industry standards" to refer only to the technical specifications published by such organizations as the American Society for Testing and Materials ("ASTM") or the American Petroleum Institute ("API"). American pipe and pipe fitting customers often treat such specifications as minimum standards and impose requirements in addition to or in excess of ASTM or API specifications where necessitated by the customers' specific safety, structural integrity or design needs. In many cases, these additional customer requirements are violated if the pipes and pipe fittings are marked by using Section 207's marking methods. In these situations, the customer frequently specifies that the pipes or pipe fittings be marked by stenciling or other appropriate method.

For example, Stelco, Inc. (a Canadian tubular producer) analyzed twenty-three oil and gas transmission pipe customer specifications. Only one permitted die stamping. When directly contacted, that customer orally reported that its specifications had not been updated and that it did not now want die stamping. The remaining customer specifications either prohibited die stamping or expressly required paint stenciling. Similarly, General Motors Corp. will not permit the die stamping of certain pipe used in its steering columns. Other examples of customer specifications that either prohibit die stamping or expressly require paint stenciling are found at pages 10-11 and 12 of the GOC Submission.

Customs should not substitute its evaluation of the effects of Section 207's marking methods for legitimate customer concerns based on years of experience. Instead, Customs should sanction customer practice in its final Section 207 regulations. Therefore, in interpreting the phrase "industry standards", Customs should include individual customer specifications that would be violated if the pipes and pipe fittings were marked using Section 207's marking methods.

Furthermore, Customs should interpret "industry standards" to include industry customs and usage. Short lengths of pipe, small diameter pipes and pipes for which surface finish is critical (such as drawn and microfinished tubing and all boiler and pressure tubing) are customarily sold or packaged in bundles that are tagged with any necessary customer information. For example, standard pipes 1.5 inches nominal in diameter are normally bundled and tagged. It is recognized throughout the industry that it would be impractical to mark individually these pipes, and thus tagging the bundles with the country of origin has been the practice in the past. Consequently, Customs should let these pipes be marked by tagging the bundles pursuant to industry customs and usage. Similarly, certain items are customarily ink stenciled, instead of paint stenciled. In these situations, Customs should allow ink stenciling.*

In summary, the CTPA agrees with Customs that alternative, reasonably permanent and legible methods of marking should be permitted if Section 207's marking methods would render the pipes and pipe fittings unfit for their intended use or if they would violate industry standards. Nevertheless, it is strongly urged that Customs include within the meaning of the phrase "industry standards" individual customer specifications and industry customs and usage.

III. CUSTOMS SHOULD PERMIT ALTERNATIVE METHODS FOR MARKING THE PIPES AND PIPE FITTINGS DESCRIBED IN THE GOC SUBMISSION.

Based upon Customs' "unfit for intended purposes" and its "industry standards" criteria, as construed above, the GOC requested in its January 24 submission that Customs permit alternative methods for marking the pipes and pipe fittings listed therein. The GOC Submission fully details its reasons for exempting each pipe and pipe fitting from Section 207's marking methods and, in general, identifies each such pipe and pipe fitting by its ASTM or API number. To summarize, the GOC Submission requests that Customs permit alternative methods for marking the following pipes and pipe fittings:

---

* Note that ink and paint stenciling is as permanent (and often more visible) than Section 207's statutory marking methods. This is demonstrated in the study conducted by Welded Tube of Canada, Ltd., a copy of which is attached as Appendix C. In addition, ink and paint stenciling survive subsequent heat treatment to a greater extent than allowable die stamping. An indicator of the permanency of ink and paint stenciling is that the stencil is normally still visible on twenty-year old line pipe after the pipe is removed from the ground.

1. Spun Iron and Steel Pipe: identified as "spun" iron or steel pipe; or as manufactured to specifications such as American Water Works Association C151; or described as "abrasion-resistant" or "wear-resistant" spun iron pressure pipe.

2. Stainless Steel and High Nickel Alloy Tubular Products: identified as being manufactured to

   (a) ASTM or ASME A213, A268, A669, A789, A270, A312, A269, A376, A790, A554, B163, B668, B677, B468, B167, B407, B423, B464, B667, A249, A688, A632, B514, B515, B516 or B517.

   (b) U.S. military specifications 1144-D, 5695, 6737, 6845-C, 8504, 8808, 8506, 8606 or 8973.

   (c) National Aeronautics and Space Administration specification Z-0007.

   (d) Manufactured from stainless steel or high nickel alloy grades meeting the following specifications or types: 405, 409, 410, 430, 439, 800, 825, 600, 625, 304, 304L, 316, 316L, 317L, 430Ti, 309, 310, 321, 322, 332, 347, S31500, S31803, N08904, N08028 and 253MA.

   See Study by Galt Laboratories Limited on the corrosive effects of die stamping, a copy of which is attached as Appendix D.

3. Mechanical Tubing: identified as "mechanical tubing"; or as ASTM A787, A512, A513 or A519.

4. Hollow Structural Sections: identified as "hollow structural sections" or "HSS"; or as ASTM A500 (A, B or C); or as manufactured to "roll over protection systems" ("R.O.P.S.") standards.

5. Oil and Gas Transmission Line Pipe: identified as "line pipe"; or as API 5L, 5LX or 5LU.

6. Oil Country Tubular Goods: identified as "casing", "oil well tubing", "drill pipe" or fittings thereof; or as API 5A, 5AC, 5AX or 5AQ.

7. Standard Industrial/Commercial Pipe: ASTM A53, A106 or A120; or identified as falling within AISI Product Code 8. Note that alternative marking only is required if such pipe is galvanized or is 1.5 inch nominal or less in diameter.

8. Electrical Conduit and Conduit Hollows: identified as "conduit"; or as ASTM A523.

9. Boiler and Pressure Tubing: identified as "boiler or pressure tubing"; or as ASTM A178, A179, A192, A210, A213 or A214.

Exempting the above-described pipes and pipe fittings would not impose an administrative burden on Customs. Such pipes and pipe fittings are currently identified (in the manner described above) on the Special Summary Steel Invoice (the "SSSI"). Item 15 of the SSSI expressly requires a description of the specifications covering the imported product. Thus, Customs officials could easily compare the above list of pipe and pipe fitting specifications with individual SSSI's to determine whether a particular entry may be marked by an alternative marking method. False statements or representations on the SSSI would be subject to Customs' normal regime of civil and criminal penalties.

In summary, based on the reasoning detailed in the GOC Submission, Customs should permit alternative methods for marking the above-described pipes and pipe fittings (i.e., ink or paint stenciling, or tagging in bundles). Such a decision would not increase Customs' administrative burden, but would instead fit with Customs' current administrative practice.

IV. CUSTOMS SHOULD GRANT A 120-DAY IMPLEMENTATION PERIOD FOR ANY MARKING RULING THAT IT MIGHT ISSUE.

The practical implementation of Section 207's marking requirements is a complex and technically sophisticated subject. Not only must Customs determine for which pipes and pipe fittings to permit alternative methods of marking, but also the size, placement and frequency of the marks for both alternative and statutory methods of marking must be responsive to varying customer needs and applications.

It is impossible for foreign pipe and pipe fitting producers to comply immediately with any final ruling issued by Customs. New equipment must be purchased, production lines revamped and new personnel hired. Equipment could not be designed and ordered during the current 120-day interim period because of the absence of Customs' rules on size, depth and frequency of the marks. Consequently, Customs should provide that any rules or regulations implementing Section 207's marking requirements would not go into effect for 120 days after their announcement and would not apply to pipes and pipe fittings produced before the end of that period. This would provide foreign pipe and pipe fitting manufacturers with a reasonable time period within which to comply with the precise rules or regulations issued by Customs.

V. CONCLUSION

Congress' intent in enacting Section 207 was "to give American buyers better consumer information about the origin of the product they are purchasing." 120 Cong. Rec. S11,768 (daily ed. Aug. 4, 1983) (statement of Sen. Mattingly). The CTPA believes that its comments permit Customs to achieve this intent without erecting a significant nontariff trade barrier. Canada is the United States' principal trading partner. By adopting a fair and reasonable interpretation of Section 207, Customs can adhere to the statute's spirit without disrupting U.S.-Canada trade.

Sincerely,

William Silverman
Attorney for the Canadian Tubular
Producers Association

WS:csd
enclosures

cc: Thomas Lindmeier (w/enclosures)
Richard Newcomb (w/enclosures)
Paula Ilardi (w/enclosures)

Statement of John B. Huffaker Relating To Refinancing of Purchase Money Obligations of ESOTS (IRC Sec. 133, Act Sec. 543 (a))

I am John B. Huffaker, an attorney with my principal office at 2000 Fidelity Building, Philadelphia, PA 19109. This statement is submitted on behalf of Cataract, Inc., a corporation with its principal office at Newtown, Bucks County, Pennsylvania.

Cataract, Inc. is in the business of leasing its employees to public utilities. They are highly skilled engineers and technicians that will work on a particular job for a period of months and then move to another site. The founder of Cataract sold his approximately 70% interest in the company to a newly created ESOT on January 2, 1985. He received cash and a Note payable over five years. The Note carries interest in compliance with the Internal Revenue Code provisions.

It was not practical to arrange for the borrowing before the purchase since the loan negotiation must be by the ESOT as the principal shareholder. After there is a contract with the potential seller, there is an urgency to close since the trustees are relying upon an appraisal that will quickly become out of date. This scenario almost dictates that the purchase of a large block must precede the borrowing.

The Company is in position to substantially reduce the cash demands posed by the Note if it can borrow the funds from a bank and prepay the Note. Or stated differently, the stock in the ESOT will be released to the accounts of the participants more rapidly as the interest component of the payments it makes are reduced. Of course, the saving would reflect the lowering of interest rates in the last six months, the spreading of the payment over a longer period and the partially tax exempt character of the interest if received by a bank. While the existing Note is a Securities Acquisition Loan in the hands of the seller, the special interest provision only applies when the holder is a bank or other financial institution described in Section 133(a).

We believe that a loan for the purpose of retiring a stock purchase obligation (wholly or partially) meets the requirements of present law. Quite literally, the loan proceeds will be used to pay for the stock or, in the terms of the statute, "to acquire employer securities," and that would seem to be a "Securities Acquisition Loan." However, a question has been raised because the ESOT already has the stock--it's an obligation to the seller of the stock that is disposed of and it could be argued that the stock was "acquired" for the Note rather than for the loan proceeds.

In such cases, it is not necessary to deny the ESOT the access to favorable financing under Sec. 133. It should not be significant whether the loan precedes or follows the sale as long as the use of the proceeds is clear. It is suggested that Sec. 133 be clarified by striking the "," at the end of Sec. 133(b)(1) and adding the following: "including the use of the proceeds to pay a purchase-money obligation incurred to the transferor of the employer securities."

This clarification will simplify the negotiation of purchases by ESOTs without offering an opportunity for successive refinancings.

Statement of Caterpillar Tractor Co.
Submitted to the Committee on Finance
In Conjunction with Hearings on the Technical Corrections Act of 1985
June 5, 1985

Caterpillar Tractor Co. would like to comment on the Technical Corrections Act of 1985. We recommend that the Committee complete the process it began last year and enact legislation regarding Export Trade Corporations (ETCs) that were not subject to the provisions of the Deficit Reduction Act.

Specifically, we urge the Committee to include former Export Trade Corps. in the 1984 tax treatment accorded present ETCs. This action would take into account the exporting that former ETCs--just like ETCs--are engaged in. Congress has not provided a method for former ETCs to terminate in an orderly fashion. We feel that it is highly appropriate for Congress to provide a termination mechanism for former ETCs--as outlined in this statement--similar to the ETC provisions in the 1984 legislation.

The Deficit Reduction Act of 1984 included important new provisions establishing Foreign Sales Corporations (FSCs). The FSC provisions were passed at the administration's request and with the full support of the business community. The FSC was designed by the U.S. Trade Representative and Treasury Department to meet trading partners' complaints against the provisions permitting Domestic International Sales Corps. (DISCs). Last year, for large exporters, Congress effectively repealed the decade-old DISC statute and replaced it with a GATT-legal Foreign Sales Corp. export incentive. Both the DISC and the FSC were designed to encourage U.S. exports and to partially offset the more favorable tax treatment accorded exports by the European community.

In the process of drawing up legislation to convert DISCs to FSCs, Congress also partially addressed the issue of Export Trade Corporations. While no new companies can now qualify for ETC benefits, Export Trade Corp. provisions have been in the tax code for decades. Companies that established ETCs found that their ETCs had to meet several standards. At least 90% of the ETC's income must have been generated outside of the United States and, of this, 75% had to be derived from U.S. exports. ETCs that failed to continue to meet these tests, however, did not forfeit the right to continue to retain deferred income. Under the present law, companies can retain their former ETCs and the corresponding deferral on previously-earned export income if such income is invested in certain qualified export assets. In a case where an ETC fails to meet the income test but can still meet the asset test, no additional new income can be deferred.

It should be pointed out that the tax laws have always treated ETCs and DISCs somewhat differently in an important way. DISCs that failed to meet all of the standards in the law immediately became subject to taxation. In other words, a DISC received favorable tax treatment only so long as it operated fully as a DISC. On the other hand, former ETCs have no termination point if they do not meet income tests. Only if asset tests are also not met would an ETC become subject to full taxation.

Additionally, Congress has not provided for all ETCs the type of phase-out mechanism it provided for DISCs last year. Some ETCs were allowed permanent tax forgiveness if they currently qualified as ETCs that met all of the income and asset tests. Active former ETCs (then falling short of the income source requirements) were given no options but continued status as a former ETC.

Consequently, last year's tax legislation did not deal comprehensively with ETCs. Rather, it focused only on those ETCs that then fully met the income standards requirement. Other ETCs that had fallen short of the income standards--but which still met the assets standards--were not covered by the 1984 legislation. The consequence of the 1984 law is that former ETCs which in 1984 were not qualified for new tax deferrals--based on the two income source tests--are left in tax limbo.

These particular ETCs are still generating exports just like the ETCs which meet the income standards. They would virtually have to do so. Otherwise they would not meet the assets test. They are, however, not generating the exact level of exports specified in the law.

Caterpillar has for decades had two (now former) export trade corporations because the company is one of the largest U.S. exporters. These companies ceased to meet the income standards many years ago but have always met the assets test. Each year the company must show to the IRS that its assets on the last day of the taxable year meet the legal requirements. As long as that is satisfied, taxes on the ETC are deferred indefinitely. In our view, this amounts to an annual paperwork and accounting burden that serves no useful purpose in light of last years' tax law changes for other ETCs.

The question we would pose to the committee is this: why should some ETCs be considered as previously taxed--as Congress did in 1984--while not offering the same treatment to the Caterpillar-type ETC? We do not see a logical reason for excluding some ETCs from the 1984 tax treatment. Extending the 1984 forgiveness to them would clean up what has become essentially a deadwood provision of the tax law.

We feel it is appropriate to address the remaining ETCs in the framework of the Technical Corrections Act of 1985. An amendment accomplishing this task is attached. Caterpillar Tractor Co. urges the Committee to add language to this effect.

99 th Congress
1st Session

H.R.

To provide relief for former export trade corporations.

IN THE HOUSE OF REPRESENTATIVES

Mr. introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To provide relief for former export trade corporations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, that

(a) Special Rule for Former Export Trade Corporations -

(1) In General.- If, before January 1, 1986, any former export trade corporation elects the benefits of this Act then any

previously excluded export trade income which is derived before January 1,1986, shall be treated as amounts included in gross income for a prior taxable year (within the meaning of section 970(b)(2) of the Internal Revenue Code of 1954).

(2) Elections. - Any election made under this Act shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may prescribe.

(3) Former Export Trade Corporation. - For purposes of this Act, the term "former export trade corporation" means any corporation which satisfied the requirements of Section 971 of the Internal Revenue Code of 1954 for one or more prior taxable years, but did not satisfy the requirements of Section 971 for the most recent taxable year ended prior to the date of enactment of the Deficit Reduction Act of 1984.

(b) Effective Date. - The amendments made by section (a) shall apply to taxable years ending after the date of enactment.

LAW OFFICES
GROOM AND NORDBERG
CHARTERED
SUITE 700
1775 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20006

(202) 857-0680
DEX (202) 659-4503

THEODORE R. GROOM
CARL A. NORDBERG, JR.
ROBERT B. HARDING
LAWRENCE J. HASS
LOUIS T. MAZAWEY
MICHAEL F. KELLEHER
IRENE PRICE
GARY M. FORD
DANIEL HOROWITZ *
STEPHEN M. SAXON
ROBERT P. GALLAGHER
DOUGLAS W. ELL
WESLEY D. WORNOM
JOHN P. McALLISTER
TERRENCE M. DENEEN
CURTIS L. MUNCY •
MARY BALENT LONG

*ADMITTED IN VA. ONLY
•ADMITTED IN CA. ONLY

HOWARD J. SILVERSTONE
OF COUNSEL

May 29, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: Comments on Technical Corrections to the Retirement Equity Act on Behalf of Chevron Corporation

Dear Mr. Chairman:

These comments on technical corrections to the Retirement Equity Act are submitted on behalf of Chevron Corporation ("Chevron"). Chevron and its affiliates (including Gulf Oil Corporation) currently maintain tax-qualified plans for the benefit of over 90,000 employees, former employees, and their beneficiaries.

Our comments may be briefly summarized as follows:

1. Where an alternate payee is entitled to benefits under a qualified domestic relations order ("QDRO"), plans should be permitted to distribute benefits at any time without adversely affecting their tax-qualified status if the plan provides for, and the alternate payee consents to, the distribution.

2. The relationship between the survivor benefit rules and the QDRO provisions should be clarified by statute. In particular, it should be confirmed that the joint and survivor rules, and the related requirement for exempted plans that 100 percent of the account balance be payable upon the participant's death to the surviving spouse, do not apply to the extent benefits have been assigned to an alternate payee by a QDRO.

3. It should be confirmed that, should an alternate payee choose to receive benefits where the participant continues working and is not fully vested, the plan is not required to increase benefits to the alternate payee to reflect subsequent vesting by the participant.

4. The Federal income and gift tax consequences of spousal waivers of benefits should be clarified.

5. The expanded spousal consent rules should also be clarified, particularly (1) with respect to the requirement that consent apply to a specific beneficiary and (2) to deal with plans which generally do not provide for payments to other beneficiaries where the spouse consents to waive survivor coverage.

6. The transition rule to avoid double death benefits should be revised or eliminated, to remove any implication that double benefits are required outside the scope of the rule.

7. The tax consequences of QDRO payments to alternate payees other than former spouses should be clarified.

These comments are set forth more fully below.

1. Where the Alternate Payee Consents and the Plan So Provides, Plans Should Be Permitted To Cash-Out or Commence Benefits Under a QDRO at Any Time, and Unilateral Cash-Outs of Small Benefits Should Be Permitted

Sections 104 and 204 of the Retirement Equity Act provide an exception to ERISA's assignment, alienation, and preemption provisions for the payment of plan benefits to an alternate payee pursuant to a qualified domestic relations order ("QDRO"). The basic purpose of these provisions was to allow state courts to divide benefits in connection with divorce, subject to certain safeguards designed primarily to minimize the burdens and potential liabilities of plans and plan administrators. One such safeguard prevents a state court from ordering a plan to commence payments to an alternate payee prior to the date the participant attains or would have attained the plan's earliest retirement age. Code §§ 414(p)(3) and (4). In our view, this safeguard by itself does not limit a plan's ability, if it so desires, to commence payments at an earlier date.

There are general restrictions under Code sections 401(a) and 401(k), which apply to some but not all tax-qualified retirement plans, on the payment of benefits prior to termination of employment.[*] The last sentence in Code section 414(p)(5) states that these restrictions do not apply to payments to an alternate payee "pursuant to a qualified domestic relations order." While we believe that this sentence was intended broadly to avoid any violation of sections 401(a) and 401(k) where payments are made to an alternate payee, the sentence could be read to avoid a violation only where the QDRO itself specifically authorizes the payment at that time.

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[*] Regulation section 1.401-1(b)(1)(i) has been interpreted to prohibit a defined benefit or money purchase pension plan from making in-service distributions prior to a participant's attaining normal retirement age. See T.I.R. 1403, Q&A M-15; IRS Letter Ruling 8453082 (Oct. 3, 1984). Code section 401(k)(2)(B) generally prohibits a qualified cash or deferred arrangement, which may be part of a profit-sharing or stock bonus plan, from making in-service distributions prior to a participant's attaining age 59-1/2.

Section 2(c)(4)(A)(v) of H.R. 2110, a bill to make technical corrections to the Retirement Equity Act, is intended to address the extent to which the sections 401(a) and 401(k) restrictions apply to payments to an alternate payee prior to any date specifically set forth in the QDRO. The proposed solution is that the restrictions would apply unless the present value of such payments does not exceed $3,500. As presently worded, the restrictions would not be waived for larger amounts, even if immediate payment is desired by the alternate payee.

In testimony before the House Ways and Means Committee on May 16, the Treasury Department suggested that the issue of whether payments may be made to an alternate payee before the participant terminates employment should not be decided on the basis of the present value of the payments. We agree. We also agree that divorce "effectively severs" the link between the alternate payee and the employer maintaining the plan, and "thus may be seen as functionally equivalent to a participant's separation from service."

In our view, the proposed sweeping restriction on payments to alternate payees is contrary to the intent of the Retirement Equity Act. It was in recognition of the possible need of a divorced spouse for immediate funds that the "earliest retirement age" exception was added. Because the exception allows a court to order payments to an alternate payee even if not provided for under the plan, the condition that the participant attain the earliest retirement age was added to minimize the administrative burdens placed on plans. Where a plan and the alternate payee both desire earlier payments, we believe the statutory purpose is further served by facilitating, rather than prohibiting, such payments.

We recommend that this distribution of benefits issue be resolved in a manner which reasonably accomodates the needs of divorced spouses and the administrative problems of plan administrators. In the case of surviving spouses of deceased participants, the solution adopted by the Retirement Equity Act to balance these needs and problems is a $3,500 rule: benefits with a present value greater than $3,500 may be cashed-out only with consent, and benefits with a present value not greater than $3,500 may be cashed-out at the plan's discretion. We believe that similar rules should apply to surviving spouses and divorced spouses, and that the $3,500 compromise of the Retirement Equity Act should be extended to divorced spouses.*/

To summarize our views on this issue, we recommend that a technical correction be adopted that would provide as follows:

1. The restrictions under Code sections 401(a) and 401(k) regarding the payment of benefits prior to the termination of employment do not apply to payments to an alternate payee under a QDRO, regardless of when made, if the plan provides for such payments.
2. Where the present value of payments to the alternate payee exceeds $3,500, such payments may be cashed-out only with the consent of the alternate payee.
3. Where such present value does not exceed $3,500, payments may be cashed-out at the discretion of the plan administrator.
4. Present value should be determined as of the date of receipt of the QDRO by the plan.

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*/ Code § 417(e). While we believe that similar rules should apply to surviving spouses and divorced spouses, we would emphasize that there is an urgent need for clarification of the scope of Code section 417(e) and the related rules of Code section 411(a)(11).

We note two differences between our recommendations above and the testimony of the Treasury Department. First, we urge that the administrative costs and burdens created by small benefits be recognized, and that the $3,500 cash-out rule of the Retirement Equity Act be expanded to include QDRO payments. Second, the Treasury statement seems to suggest that the Code sections 401(a) and 401(k) restrictions would not apply only where the QDRO itself authorizes payments prior to the termination of employment. In that event, because a QDRO may not order payments to be made prior to the participant's attainment of the earliest retirement age, payments to the alternate payee prior to that time might violate sections 401(a) or 401(k) if the participant remains in service.

These apparent limitations fail to recognize that the policy underlying the cash-out rules applies whenever a plan is confronted with the task of accounting for benefits, particularly small benefits, with respect to individuals who are no longer connected with the employer or the plan. Specifically, the cash-out rules recognize that it may be exceedingly difficult for plans to maintain current information regarding the whereabouts of such persons. This problem is particularly acute for defined contribution plans that provide for directed investments and where there may be a need for regular contact with alternate payees with respect to investment matters. We would emphasize also that rules which provide plans with reasonable flexibility to deal with these problems through cash-outs will not prevent alternate payees from preserving their funds for retirement purposes, because (1) Code section 402(a)(6)(F) expressly allows tax-free rollovers of amounts received under QDROs and (2) plan administrators are required under Code section 402(f) to notify recipients of opportunities to make such rollovers. Accordingly, we believe that the sections 401(a) and 401(k) restrictions should not apply to QDRO payments whenever made, and that the divorced spouse's interests are adequately protected if written consent is required to cash out benefits exceeding $3,500.

2. The Relationship Between the Survivor Benefit Requirements and QDROs Should Be Confirmed in the Statute

Sections 103 and 203 of the Retirement Equity Act generally require that a preretirement or post-retirement survivor annuity be paid to the spouse of a deceased vested participant, unless the spouse consents in writing to waive the benefit. Certain profit-sharing and stock bonus plans are generally exempted from these survivor benefit requirements, but only if 100 percent of the account balance will be paid to the surviving spouse upon the participant's death (unless the spouse consents otherwise).

One very important question in this area is as follows. Where a QDRO assigns a portion of a participant's accrued benefit to a divorced spouse or other alternate payee, and the participant remarries and then dies, are the benefits assigned by the QDRO to the first divorced spouse excluded for purpose of computing the survivor benefits payable to the second spouse? Although the statute does not address this important issue, we think the legislative history makes it clear that a plan is not required to pay the same benefit twice, i.e., to both spouses. The final Senate Report on the Retirement Equity Act states that:

> "This rule [presumably referring to the general joint and survivor rules] does not apply, however, if a qualified domestic relations order . . . otherwise provides for the division or payment of the participant's retirement benefits. For example, a qualified domestic relations order could provide that the former spouse is not entitled to any survivor benefits under the Plan."

S. Rep. No. 575, 98th Cong., 2d Sess 16 (Aug. 6. 1984). Similarly, the helpful examples provided by Representative Clay, Chairman of the House Subcommittee on Labor-Management Relations, during the final House debate on the Retirement Equity Act specifically indicated how portions of the participant's accrued benefit would be converted into payments to adivorced spouse and a surviving spouse in this situation. See 130 Cong. Rec. H8761-62 (Aug. 9, 1984).

Although it was clearly contemplated that a plan would not have to pay the same benefit to both the divorced spouse and the surviving spouse, there is no explicit "carve out" in the survivor benefit rules for benefits previously assigned under a QDRO. Moreover, in the case of an exempt profit-sharing or stock bonus plan that generally provides 100 percent of the account balance to the surviving spouse in the event of death, there is no specific statutory provision that benefits need not be paid to the surviving spouse to the extent previously assigned to an alternate payee under a QDRO. In this regard, we are very concerned that courts might interpret the foregoing legislative history as applying only to those plans which are generally subject to the joint and survivor rules, and not to individual account plans which are exempt from such rules pursuant to Code section 401(a)(11)(B)(iii).

We believe these extremely important issues merit statutory confirmation. Otherwise, surviving spouses may assert that they have a statutory right to unreduced benefits, and plans will be in danger of having to make double payments.

3. Where an Alternate Payee Chooses To Receive Benefits While the Participant Continues Working and Is Not Fully Vested, It Should Be Confirmed That the Plan is Not Required To Increase Benefits to the Alternate Payee To Reflect Subsequent Vesting

In some cases a participant will not be fully vested upon reaching a plan's earliest retirement age (within the meaning of Code section 414(p)(4)(B)). A divorced spouse may nevertheless wish to receive benefits beginning at that date, rather than wait until the participant may become fully vested, and a QDRO may provide for such earlier receipt of benefits.

Section 414(p)(4)(A)(ii) indicates that, where the alternate payee chooses to receive benefits before the participant terminates plan participation, the alternate payee's entitlement is based on the benefits accrued as of the date on which payment is to begin under the QDRO. We request confirmation that, in such cases, the plan is not required to provide increased or additional benefits to the alternate payee whenever the participant's vesting percentage increases. This is consistent with the initial report of the Senate Finance Committee on the Retirement Equity Act:

> The special rule provides that in the case of a participant who has attained the earliest retirement age applicable to the participant under a plan, an order will not fail to be a qualified order merely because it requires a plan to pay benefits to an alternate payee in an amount determined as if the participant had retired at that time. Accordingly, the benefit payable to the alternate payee would not reflect subsequent benefit accruals or vesting by the participant.

S. Rep. No. 285, 98th Cong., 1st Sess. 19 (Oct. 29, 1983). To our knowledge, this vesting issue is not specifically addressed in subsequent reports or explanations.

A related issue is whether, in this same situation where the divorced spouse receives benefits and the participant continues working, the divorced spouse is entitled to share in any early retirement subsidy. The compromise reached on this second issue was that the divorced spouse would not be entitled to the subsidy unless the participant subsequently retires to qualify for the subsidy and the QDRO provides for increased payments to the divorced spouse in that event. See S. Rep. No. 575, 98th Cong., 2d Sess. 21 (Aug. 6, 1984). The apparent purpose of this compromise was to minimize "game playing" by participants at the expense of the divorced spouse. It was believed that a participant might otherwise delay retirement until the divorced spouse began to receive payments, so that the full value of any subsidy might be retained by the participant.

This opportunity for "game playing" does not exist in the vesting area, because the expected increase in the vesting percentage each year will be readily apparent and the divorced spouse can determine whether to wait for possible further vesting or receive immediate payments. In addition, the administrative burdens placed on plans if recalculation and increased benefits were required would frequently be substantial. Many plans provide for graduated vesting over a period of years, and recalculation could thus be required 5 or even 10 times in the case of some QDROs. One way to clarify this point would be to revise the parenthetical language contained in section 414(p)(4)(A)(ii) to read as follows (new matter underlined):

> (but taking into account only the present value of the benefits which were actually accrued and nonforfeitable as of such date and not taking into account the present value of any employer subsidy for early retirement)

4. The Federal Income and Gift Tax Consequences of Spousal Waivers of Benefits Should Be Clarified

A spouse may consent to waive post-retirement survivor beneits, preretirement survivor benefits, and the right to receive 100 percent of the account balance in an exempt profit-sharing or stock bonus plan. An area of considerable confusion is in what situations, if any, are benefits nevertheless taxable to the spouse under assignment of income principles? One argument is that, because benefits payable under qualified plans are only taxed when actually paid to the recipient, spouses should not be taxed on death benefits that they consent to forego in favor of another beneficiary. In any event, if spouses are to be taxed on death benefits they consent to waive, this important consequence should be clearly understood by spouses.

A similar problem arises in the gift tax area. Because consent is irrevocable by the spouse, it could be argued that a gift takes place at the time the consent is given. In this regard, we note that section 152(e)(2)(A) of S. 814 would repeal section 2517 of the Code, which currently eliminates up to half of the potential gift tax liability, at least in community property states. Also, it appears that spousal consent of payment to a designated beneficiary would not constitute a "qualified disclaimer" under Code section 2518 and thus the exception provided by that section would be unavailable.

Section 2(f)(1) of H.R. 2110 contains a special transition rule for certain spousal waivers made on or before the close of first plan year to which the Act applies. The proposed statutory language states that such waivers would not result in gift tax, and the May 14, 1985 explanation of the bill by the Joint Committee staff indicates that such waivers would not increase a spouse's income. These provisions imply that waivers outside of this very limited transition period generally will have income and gift tax consequences to consenting spouses. If intended, these important results should be explicitly stated and clarified. For example, does the "gift" take place when the waiver is signed or when the benefit is paid?

5. The Proposed Amendments to the Spousal Consent Rules Should Be Clarified

Section 2(b)(6) of H.R. 2110 would amend the spousal consent rules to provide that consent is only effective where (1) the spouse "designates a beneficiary" which may not be changed without spousal consent, or (2) the consent specifically permits designations of beneficiaries by the participant without any requirement of further consent by the spouse.

We have several comments on these provisions. First, the proposed language could be interpreted to require the election to designate a beneficiary in all cases if the spousal consent is to be effective. Assume, however, a defined benefit plan where the spouse's consent to an election out of the preretirement or post-retirement survivor coverage results in the participant's receipt of larger annuity benefits and no death benefits payable to any other person. In order to deal with this common situation, proposed section 417(a)(2)(A)(ii) could be revised to include the following underlined language at the beginning thereof: "if the plan provides for designation of another beneficiary where such election is made, such election designates a beneficiary which may not be changed without spousal consent . . . ."

Second, the "designates a beneficiary" concept raises a variety of questions in terms of exactly how specific the designation must be, the effects of subsequent events, etc. For example, we would appreciate clarification in the committee report of how the following situations would be resolved.

1. Spouse consents to payment to "my child" or "my children" at the time when the spouse and participant have one child. A second child is born. Does either of the above consents permit division of the benefits among the two children, or is a new consent required?

2. Spouse consents to payment of equal shares to two children. May the participant subsequently designate that 60 percent of the benefits will be paid to the first child and 40 percent to the second? What if the spouse had consented to payment to "my children" without further elaboration?

3. Spouse consents to payment to a trust. May the participant redirect payments to a second trust? What if the beneficial ownership of the two trusts is identical?

4. May the spousal consent limit the form of payment to the other beneficiary? For example, suppose the spouse specifies that the beneficiary will receive payments in the form of a life annuity. May the participant direct that benefits be paid to this same beneficiary in a lump sum?

Finally, we support the provision of the bill which would allow the spouse to provide a one-time consent to beneficiary designations which may be made or changed in the future. In this regard, we disagree with the Treasury Department position that such "blanket consent" would seriously erode the original policy of the rules. We would expect that there will be a number of cases where (because of precise personal financial circumstances) spouses are willing to forego any direct interest in the participant's benefits and will not want to be bothered with having to provide additional consents as the participant changes beneficiaries. We also believe that, with relatively few exceptions, most individuals will understand the distinction between consenting to a specific beneficiary and providing a blanket consent. Accordingly, we recommend that this type of flexibility for plan participants and their spouses be preserved.

6. The Transition Rule To Avoid Double Death Benefits Should Be Revised Or Eliminated, To Remove Any Implication that Double Benefits Are Required Outside the Scope of the Rule

Section 2(f)(1) of H.R. 2110 provides that, in the case of a plan participant who dies before the expanded survivor annuity rules apply to the plan in general, but whose surviving spouse is nevertheless entitled to benefits because of the special rule of section 303(c)(2) of the Retirement Equity Act, the amount of any death benefit payable to any beneficiary may be reduced by the amount required to be provided to the surviving spouse. We understand that this provision was intended to help plans by making it clear that the same benefits do not have to paid twice, *i.e.*, to both the designated beneficiary and the surviving spouse.

Unfortunately, this provision leaves the strong negative implication that plans may be required to pay the same benefit twice where a participant dies after the survivor benefit rules are generally applicable to the plan. For example, take the case of a calendar year single employer plan, for which the expanded survivor benefit rules became effective January 1, 1985. Many such plans have not yet been amended to incorporate the new requirements, and thus the terms of the plan may currently provide for payment to a nonspouse beneficiary. Such plans are not required to be amended to reflect the new rules until the end of 1985 (retroactive, of course, to the beginning of 1985). Section 2(f)(1) of H.R. 2110 leaves the strong implication that, where a participant in such a plan dies in 1985 before the plan is amended, double payment of the same benefit is required. While we assume that such a result was not intended, we are very concerned that courts might interpret the provision to require double payments.

We suggest that this transition rule should be broad and not be limited to participants who die before the survivor benefit rules apply to the plan. Another possible approach is to delete section 2(f)(1) and address this important issue in the committee report. Thus, for example, the legislative history could make it clear that the general intent of Congress was that survivor benefits which were mandated by section 401(a)(11) and section 417 (including the transition rules) are to be offset against benefits payable to other beneficiaries so that plans would only have to pay the same benefits once.

In addition, it should be made clear that, merely because the election period ends with the participant's death, a surviving spouse may still voluntarily disclaim any interest in the participant's benefits (e.g., for estate tax purposes) after the participant's death as long as the applicable rules are followed (subject to such income, estate, and gift tax consequences as may attach to such disclaimer). In this regard, we see no reason why plans should be forced to pay benefits directly to surviving spouses who make proper disclaimers in favor of another person.

7. The Tax Consequences of QDRO Payments To Alternate Payees Other Than Former Spouses Should Be Clarified

Section 2(c)(1) of H.R. 2110 would amend Code section 402(a)(9), which relates to the tax treatment of an alternate payee receiving benefits under a QDRO. We understand that the intent of the amendment is generally to tax the participant on a QDRO payment if not made to a spouse or former spouse. For example, we understand that QDRO payments to a child would be taxed to the parent participant.

Although the apparent intent of this change is to minimize tax planning opportunities to divorcing spouses (and to prevent indirect deductions of child support payments), it does raise a number of important questions. We request that the related tax consequences of this amendment be clarified. In particular:

1. If a QDRO payment is made to a child, should information reporting on Form 1099R (or Form W-2P) be made as if the payment were made to the parent participant? We assume that such reporting would be appropriate.
2. Do the pension withholding rules under Code section 3405 apply to QDRO payments to a child, and, if so, how? For example, who should receive notice or elect out? Because of the lack of symmetry between the recipient of benefits and the payor of tax, we suggest that such payments be totally exempt from withholding.

3. May the child roll over QDRO payments to an IRA pursuant to Code section 402(a)(6)(F)? If so, is the parent's tax liability reduced? We assume that the child would be taxed on subsequent IRA distributions.

4. Does Code section 402(e)(4)(M) continue to apply to permit possible lump sum treatment with respect to other benefits taxed to (and in this case actually paid to) the parent participant?

We would emphasize that these are real issues of immediate concern to participants and plans. For example, Chevron would like to amend its section 402(f) notices to benefit recipients to provide guidance with respect to issues 3 and 4 above. Clarification of these issues, either in the statute or in the committee report, would be extremely helpful.

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We appreciate this opportunity to comment. We would be pleased to discuss any of the above matters further with you or your staff.

Very truly yours,

Louis T. Mazawey

Douglas Ell

Douglas W. Ell

JEROME E. HYMAN
EDMUND H. KERR
MARK W. FRAWLEY, JR.
GEORGE DE SIPIO
ANDRE W. G. NEWBURG
JAMES C. BLAIR
WALTER B. ROTHSCHILD
RICHARD C. PUGH
GEORGE WEISZ
THOMAS H. HAGOORT
NED B. STILES
SYDNEY M. CONE, III
ALAN APPELBAUM
EDWIN B. MISHKIN
GEORGE H. COHEN
STEPHEN L. DINCES
J. SPEED CARROLL
PETER S. PAINE, JR.
ANTHONY C. GOOCH
ROGER W. THOMAS
ALBERT E. PERGAM
GEORGE J. GRUMBACH, JR.
PETER KARASZ
LOUIS KAHN
MARK A. WALKER
LESLIE B. SAMUELS
ALLAN G. SPERLING
PETER H. DARROW
JAMES F. MUNSELL
SANDRA S. WEIKSNER
EVAN A. DAVIS
J. WEBB MONIZ
MARIETTA POERIO
ALAN S. DUNNING
CHRISTOPHER H. LUNDING
LAURENT ALPERT
BARRY M. FOX
JUDITH A. RIPPS
VICTOR I. LEWKOW
LESLIE N. SILVERMAN
ROBERT L. TORTORIELLO
A. RICHARD SUSKO
STEPHEN H. SHALEN
RICHARD F. ZIEGLER
JAMES M. PEASLEE
ALAN L. BELLER
THOMAS J. MOLONEY
DAVID G. SABEL
EDWARD D. KLEINBARD
RESIDENT PARTNERS

CLEARY, GOTTLIEB, STEEN & HAMILTON
ONE STATE STREET PLAZA
NEW YORK, N.Y. 10004
—
(212) 344-0600
—
CABLE: CLEARGOLAW
TELEX:
WUI 62985
RCA 238430
FACSIMILE:
TELECOPIER: GPS 1/2/3 (212) 480-0158
RAPIFAX: (212) 483-1261
FAX GPS: (212) 344-0823

GEORGE E. CLEARY
[illegible]
FOWLER HAMILTON
(1911-1984)
—
LEO GOTTLIEB
MELVIN C. STEEN
GEORGE W. BALL
LYMAN M. TONDEL, JR.
JAMES G. JOHNSON, JR.
COUNSEL
—
1752 N STREET, N.W.
WASHINGTON, D.C. 20036
(202) 728-2700
TELEX: 440807
FAX GPS 2/3 [illegible]
FAX GPS 1/2/3 [illegible]
—
41, AVENUE DE FRIEDLAND
75008 PARIS, FRANCE
1-563-1004
TELEX 650091
FAX GPS: [illegible]
FAX GPS: [illegible]
—
RUE DE LA LOI 23, BTE 5
1040 BRUSSELS, BELGIUM
2-230-2060
TELEX: 22638
FAX GPS: [illegible]
FAX GPS: [illegible]
—
WINCHESTER HOUSE
77 LONDON WALL
LONDON EC2N 1DA, ENGLAND
1-638-5291
TELEX: 887659
FAX GPS: [illegible]
FAX GPS: [illegible]
—
PRINTING HOUSE
18 ICE HOUSE STREET
HONG KONG
5-214122
TELEX: 60401
FAX GPS: [illegible]

May 30, 1985

George Yin, Esq.
Counsel
Senate Finance Committee
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20515

Re: Section 104(d)(1) of the
Technical Corrections Bill of 1985

Dear Mr. Yin:

This letter comments on section 104(d)(1) of the Technical Corrections Bill of 1985, which seeks to amend the definition of certain types of preferred stock that are not treated as "stock" for purposes of the affiliation rules of section 1504(a).[1]

Section 1504(a), as amended by the Tax Reform Act of 1984, generally provides that a subsidiary may join with its parent in filing consolidated federal income tax return only if the parent and other affiliates own stock of the subsidiary representing at least 80 percent of the voting power and 80 percent of the value of all of the outstanding stock of the subsidiary. Solely for purposes of these affiliation rules, section 1504(a)(4) excludes from the definition of "stock" nonconvertible, nonvoting, nonparticipating preferred stock with certain redemption and liquidation features. (For convenience, I will refer in the remainder of this letter to section 1504(a)(4) as the "non-stock" exception to the affiliation rules of section 1504(a).) In particular, section 1504(a)(4)(C) currently excludes from the scope of the "non-stock" exception to the affiliation rules preferred stock that has redemption and liquidation rights that exceed the "paid-in capital or par value represented by such stock" by more than a reasonable redemption premium.

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[1] All citations to section numbers not identified as in the Technical Corrections Bill are to the Internal Revenue Code of 1954, as amended to date (the "Code").

The Technical Corrections Bill would amend section 1504(a)(4)(C) by striking the reference to "paid-in capital or par value" and substituting the term "issue price." The Description of The Technical Corrections Act of 1985, prepared by the Staff of the Joint Committee on Taxation, April 4, 1985 (the "Staff Description"), amplifies the proposed statutory change by stating that: "In general, the issue price of stock is its fair market value upon issuance." Staff Description at 15.

The apparent purpose of section 1504(a)(4)(C) is to treat as "stock" for affiliation purposes preferred stock that, by virtue of having redemption and liquidation rights substantially in excess of the shareholder's original investment, enables the shareholder indirectly to participate in the long-term growth of the corporate enterprise. New York State Bar Association, Tax Section, Committee on Corporations, Report on Tax Reform Act of 1984 Amendments to Section 1504(a), the Definition of "Affiliated Group", Feb. 19, 1985, at 34 (the "NYS Bar Report"). Under this analysis, section 1504(a)(4)(C) serves a role that is essentially similar to the requirement of section 1504(a)(4)(B) that, in order to qualify as "non-stock", a preferred stock must "not participate in corporate growth to any significant extent."[1]

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[1] A convincing argument can be made that an original issue discount preferred stock should not be viewed for purposes of section 1504(a)(4) as a participating preferred stock, for the simple reason that a fixed market-rate yield, whether paid currently or accrued, should not be analyzed as a participation feature. See NYS Bar Report at 29-30. If, for example, one were to couple a fixed dividend preferred stock with a dividend (Footnote continued)

The change proposed by the Technical Corrections Bill is, in part, intended to make irrelevant the different definitions under the corporate laws of the fifty States of the terms "par value" or "paid-in capital." Staff Description at 15. In addition, I understand that concern has been expressed that the current statute would not permit the recapitalization of a company's common stock into a new

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reinvestment plan providing for the purchase of additional shares of the same class of stock, the result would be a security that, as an economic matter, would be indistinguishable from a true original issue discount preferred stock. (From a tax point of view, one technical difference would remain, because fixed dividends payable annually, when coupled with a dividend reinvestment plan, would result in dividend income that increased each year on a "constant interest" schedule, while the section 305 regulations still require that dividend income on an original issue discount preferred stock be accrued on a straight line basis.) Nonetheless, I believe it clear that a dividend-paying preferred stock coupled with a dividend reinvestment plan would not run afoul of section 1504(a)(4)(C), while a true original issue discount preferred stock apparently would not qualify for the "non-stock" exception to the affiliation rules.

On the other hand, it is possible to construct a preferred stock with liquidation and redemption rights substantially in excess of the shareholder's original investment where that excess does not serve the purpose of giving holders a market-rate return on their investment. A perpetual preferred with a liquidation preference substantially greater than the shareholder's original investment would be the most common example of such a security. In such cases, section 1504(a)(4)(C) would serve a useful role, because in such cases the liquidation rights of the preferred stock in question do represent a claim on the future growth of the enterprise. Ideally, then, section 1504(a)(4)(C) and its implementing regulations should distinguish between preferred stock on which a holder receives a compounded market-rate return at the end of a fixed period of time, and preferred stock that reserves for a holder a contingent claim against the future growth of the corporation.

preferred stock qualifying for the "non-stock" exception of section 1504(a)(4) in those circumstances where the issuer lacks sufficient statutory capital to meet the requirements of section 1504(a)(4)(C). NYS Bar Report at 30-31. While these objectives certainly have merit, I do not believe that the Technical Corrections Bill should cure current law's deficiencies by creating a new unfairness.

Consider, for example, the following hypothetical case. A parent corporation ("Parent") and its wholly-owned subsidiary ("Subsidiary") file consolidated federal income tax returns. Subsidiary has suffered business and financial reverses, and accordingly has negotiated a restructuring of its outstanding long-term debt obligations with its third-party creditors. Under this workout plan, Subsidiary's long-term creditors will exchange their debt claims against Subsidiary for a package of new Subsidiary equity securities, consisting of: (i) nonvoting, nonparticipating, nonconvertible preferred stock of Subsidiary with a relatively low dividend rate and a redemption and liquidation value equal to the aggregate face amount of the creditors' current claims, and (ii) common stock of Subsidiary representing, after issuance, 20 percent of Subsidiary's outstanding common stock. The Subsidiary preferred stock will be mandatorily redeemable out of a specified percentage of Subsidiary's future net cash flow. Because the timing of those flows is not certain, and because the Subsidiary preferred will bear a relatively low dividend, the new preferred stock is expected to have a fair market value on issuance that is less than its redemption and liquidation value.

The terms of the above hypothetical restructuring are, I believe, consistent with the types of workout agreements that actual creditors and corporate debtors regularly negotiate. In my hypothetical case, Subsidiary has relieved itself of an unmanageable debt service obligation. At the same time, however, Subsidiary's creditors have preserved their rights to the return of the monies they originally advanced to Subsidiary as promptly as Subsidiary's operating cash flow permits. As compensation to the creditors for agreeing to forego their rights to press Subsidiary for immediate payment, Subsidiary and Parent, through the issuance of Subsidiary common stock to Subsidiary's creditors, have given those creditors a 20 percent interest in the long-term growth of Subsidiary. Thus, Subsidiary's new preferred stock serves the purpose simply of deferring to the future Subsidiary's present obligation to repay to its creditors the principal of the monies previously advanced by them, while removing from Subsidiary the specter of default on its debt obligations. The creditors must look to their Subsidiary common stock, not their preferred stock, for any participation in the future growth of Subsidiary.

If, instead of issuing the above package of preferred and common stock, Subsidiary were to issue a new debt instrument having a nominal interest rate but a face amount equal to the face amount of its currently-outstanding debt, the result under section 1275(a)(4) would be that the "issue price" of the new debt would equal the face amount of the old debt.[3] Accordingly, Subsidiary would not recognize any discharge of indebtedness income, and, because third-party indebtedness is ignored for purposes of the affiliation rules of section 1504(a), Parent and Subsidiary could continue to file consolidated returns.

I do not believe that any tax policy purpose is served by requiring Subsidiary in this case to issue debt rather than preferred stock in order to preserve tax affiliation with Parent. The purpose of section 1504(a)(4)(C) is to exclude from the scope of the "non-stock" exception to the affiliation rules disguised participating preferred stock.

Any preferred stock issued in a recapitalization that seeks, in effect, to freeze a security holder's current claim against a corporation should not be characterized as a disguised participating preferred stock, for the reason that such a preferred stock's purpose is to cut off the holder's claim against the future growth of the enterprise by limiting that claim to its current level. I recognize that, as observed above, current law may be inadequate to this task when common stock is recapitalized into preferred stock. At the same time, however, the Technical Corrections Bill would make impossible the recapitalization of existing third-party debt into preferred stock, unless the parties were able to predict with certainty what the value of that new preferred stock would be. In the case of negotiated workouts of corporations in financial distress, the parties typically would be unable to make such predictions as to how the marketplace might value such new preferred stock.

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[3] I assume, of course, that the old debt was not issued at a discount.

I believe that the problem identified in this letter can be resolved without vitiating the appropriate application of section 1504(a)(4)(C) by revising the definition of "issue price" in section 1504(a)(4)(C) to contain a rule analogous to section 1275(a)(4)'s special definition of "issue price" for purposes of applying the original issue discount rules to bond-for-bond recapitalizations. Under this suggested approach, when a new preferred stock is exchanged for an outstanding debt instrument in a recapitalization or other reorganization, the "issue price" of the new preferred stock for purposes of section 1504(a)(4) would be deemed not to be less than the adjusted issue price of the old debt instrument exchanged therefor.

In order to implement this suggested definition of "issue price" in recapitalizations, the amended Code or the legislative history to the Technical Corrections Act should articulate an ordering rule for determining that "issue price" where (as in my earlier example) an outstanding debt obligation is retired for a package of new securities. To accomplish the purpose of the proposed definition of "issue price," the principal amount of the outstanding debt should be deemed retired for section 1504(a)(4)(C) purposes in the following order: first, the principal amount of the outstanding debt should be reduced, dollar-for-dollar, by any cash distributed; second, the remaining principal amount should be reduced by the principal amount of any new debt securities issued in the recapitalization exchange; and finally, the redemption/liquidation value of the preferred stock issued in the exchange should be applied against the remaining principal amount of the outstanding debt to determine the "issue price" of the new preferred stock. Under this ordering rule, so long as the redemption/liquidation value of a new preferred stock issued in a recapitalization is no greater than the principal amount of the old debt (reduced by any cash and by the principal amount of any new debt issued in the exchange), the "issue price" of the new preferred stock would be deemed to be equal to its redemption/liquidation value, without regard to any common stock that might also be issued in the exchange.

This proposed ordering rule is similar in concept to, and would serve the same purpose as, the ordering rule contained in the legislative history to the Bankruptcy Tax Act of 1980 for applying the stock-for-debt exception to the discharge of indebtedness income rule in the case of a recapitalization exchange involving a package of new securities.[8] In each case, the proposed ordering rule has the effect of facilitating the rehabilitation of distressed corporations, and of avoiding difficult valuation issues. In the context of section 1504(a)(4)(C) and the example I gave earlier, any other ordering rule (for example, a rule that would require the allocation of the principal amount of the outstanding debt between the new preferred stock and new common stock based on their relative fair market values) would reintroduce the very valuation uncertainties that the suggested definition of "issue price" for recapitalization exchanges is meant to cure.

The above proposal for a special definition of "issue price" in recapitalizations would, I believe, bring section 1504(a)(4)(C) into line with the Code's definition of "issue price" for original issue discount purposes. The proposal would also permit corporate subsidiaries flexibility in using preferred stock to recapitalize without running afoul of section 1504(a)(4), so long as that new preferred stock, in economic effect, freezes a holder's claims against the issuing corporation at current levels. At the same time, a preferred stock with a true participation feature would continue to fall outside the "non-stock" exception of section 1504(a)(4) just as a new bond issued in exchange for an old bond will be subject to the original issue discount rules when the face amount of that new bond exceeds the adjusted issue price of the old bond.

If you have any questions concerning this letter, I would be pleased to discuss these matters with you at your convenience.

Very truly yours,

Edward D. Kleinbard

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[8] Sen. Rpt. No. 96-1035, 96th Cong., 2d Sess., 17.

LAW OFFICES OF
DAVIS & HARMAN
METROPOLITAN SQUARE
655-15TH STREET, N.W.
SUITE 250
WASHINGTON, D.C. 20005

(202) 628-4480

June 11, 1985

Mr. William Diefenderfer
Chief of Staff
Committee on Finance
Washington, D.C. 20510

Dear Mr. Diefenderfer:

The enclosed comments on the Technical Corrections Act of 1985 are submitted for consideration by the Committee on Finance on behalf of our client, the Committee of Annuity Insurers. We respectfully request that their statement be included in the printed hearing record of June 5, 1985.

Sincerely,

Gail Wilkins
Gail Bramblett Wilkins

GBW/aif
Enclosures

STATEMENT OF
COMMITTEE OF ANNUITY INSURERS

The Committee of Annuity Insurers, a coalition of 25 of the leading annuity companies in the United States, appreciates this opportunity to offer comments on S. 814, the Technical Corrections Act of 1985. Our Committee, a list of the member companies of which is attached, was formed in 1981 to monitor legislative and regulatory issues affecting the annuity industry and annuity policyholders. As such, we worked closely with the Ways and Means Committee and the Finance Committee in the development of the life insurance tax provisions in the Deficit Reduction Act of 1984 (the "1984 Act").

Part B of Title I of the Technical Corrections Act of 1985 would amend the provisions of the 1984 Act relating to life insurance company and life insurance product taxation. The Committee of Annuity Insurers would like to focus its comments on the amendments in Part B which relate to the annuity product. In particular, we will specifically address the proposed amendments to sections 817(h) and 72 of the Code.

S. 814 would resolve a number of the issues which have arisen under the 1984 Act in connection with the annuity product. While we applaud the authors of this legislation for their efforts in this regard, we would like to suggest other amendments which we feel merit the Committee's consideration. In addition, we would like to bring to the Committee's attention three provisions in the Technical Corrections Act which we believe are substantive changes and therefore should not be incorporated in a technical corrections bill. These provisions relate to the treatment of section 403(b) annuities, the applicability of section 72(s) to gratuitous transfers of annuity contracts, and the applicability of the penalty tax to distributions at the death of the annuitant.

Section 817(h) of the Code

Section 817(h) of the Code, as amended by the 1984 Act, provides that a variable contract (other than a pension plan contract), which is based on a segregated asset account, shall not be treated as an annuity, endowment, or life insurance contract for any period for which the investments made by such account are not "adequately diversified." In general, section 817(h)(1) calls for the requisites of "adequate diversification" to be spelled out in regulations that the Internal Revenue Service (the "Service") is to issue. However, the effective date for new section 817(h)(1) under the 1984 Act is January 1, 1984 -- the general effective date for the life insurance company tax provisions in the 1984 Act.

The legislative history of section 817(h)(1) indicates that Congress intended that the regulations called for under this provision would have a prospective effective date. As noted in the Senate Report explaining the revenue provisions of the 1984 Act and again in the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the "Blue Book"), the Congress "anticipated that any regulations prescribing diversification standards changing current practices will have a prospective effective date."

The Internal Revenue Service has not, as yet, promulgated regulations under section 817(h)(1). However, last year a temporary regulation was issued by the Service which provides as follows:

> "(a) In general. Any temporary regulations issued under the authority of section 817(h), relating to the diversification requirements for variable annuity, endowment, and life insurance contracts, will be effective for taxable years beginning after December 31, 1983.
>
> (b) Exception. If an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81-225, 1981-2 C.B. 12, at all times after the later of December 31, 1983, or the date on which the segregated asset account was established, the temporary regulations described in paragraph (a) of this section will not apply to such account until 90 days after their publication in the FEDERAL REGISTER."

In light of the foregoing, two questions have arisen as to the effective date of any regulations issued pursuant to section 817(h)(1) of the Code. First, what effect, if any, should such regulations have on situations that have been grandfathered (pursuant to section 7805(b) of the Code) in Rev. Rul. 77-85, Rev. Rul. 80-274, and Rev. Rul. 81-225, and various private letter rulings thereunder, as well as on situations where the funds involved have been "closed" pursuant to Rev. Rul. 82-55? Second, how much time should insurance companies be given to diversify their separate account investment portfolios in accordance with the proposed regulations? Although section 121(l)(1) of the

Technical Corrections Act makes a number of changes to section 817(h) of the Code, it does not address these effective date issues.

1. "Grandfathered" Situations.

The industry is concerned about the possible effect the forthcoming regulations may have on situations covered by published and private letter rulings of the Service under prior law. In Rev. Rul. 77-85 (relating to investment annuities), policyholders were held to be the owners of assets held in custodial accounts created thereunder, but "grandfathering" relief was provided such that those accounts were treated as segregated asset accounts of the issuing insurance company (under former section 801(g)(1) of the Code) in the case of contracts entered into and contributions received thereunder prior to March 10, 1977. Similarly, in Rev. Rul. 81-225, the Service described the situations in which an insurance company would not be deemed to be the owner of the underlying assets of so-called mutual fund "wraparound" annuities, but again "grandfathering" relief was accorded in the case of premiums paid on or before December 31, 1980. Moreover, several private rulings were issued grandfathering earlier private rulings which had been issued prior to the publication of Rev. Rul. 80-274 (which reached a conclusion contrary to the prior private rulings). Furthermore, in reliance on the foregoing published rulings (as well as Rev. Rul. 82-55) a number of funds were closed to further purchase by the public and ceased receiving contributions with respect to nonqualified annuity contracts. Although these funds continue to exist today, no new money is being received either from existing nonqualified policyholders or new nonqualified policyholders.

It appears that Congress intended new section 817(h) to apply prospectively. Applying this principle to the section 7805(b) relief provisions in various published and private rulings that had been issued prior to the passage of section 817(h), as well as to funds "closed" in reliance on such published rulings, it would appear that Congress clearly intended that such situations were not to be affected by new section 817(h). In order to implement this intent, it is suggested that the following provision be added at the end of section 121(l)(1) of S. 814:

> "(6) Paragraph (1) of this subsection shall not apply to
>
> (A) any variable contract that was the object of the relief provision of section 7805(b) found in Rev. Rul. 77-55, Rev. Rul. 80-274, or Rev. Rul. 81-225 or private letter rulings thereunder; or
>
> (B) any variable contract which is based on an account which has been closed to the public in accordance with Rev. Rul. 82-55, and none of the assets of which are attributable to premium payments made by annuity purchasers in connection with contracts other than pension plan contracts after December 31, 1980."

2. Adequate Time to Diversify.

Prior to the enactment of section 817(h) of the Code, there were no statutory or regulatory standards for diversification of segregated asset accounts underlying variable contracts. While representations as to diversification had been required by the Service in connection with the submission of private letter ruling requests, these representations underwent substantial and continuous change over a period of several years. As a result, the Service issued favorable rulings to various companies with inconsistent diversification representations.

In light of these factors, promulgation of regulations on other than a prospective basis would be unfair and would create unnecessary administrative and market disruption. Furthermore, the change period should be of sufficient length to permit companies to alter their investments to meet the applicable diversification requirements. At minimum, companies should be given one year from publication of the final regulations to diversify their portfolios. Allowance of a one year period would be consistent with the Service's current practice, in the case of private rulings, of allowing newly formed insurance companies or separate accounts 365 days within which to diversify their investment portfolios adequately.

In addition to the effective date problem, the Committee of Annuity Insurers wishes to call to the Committee's attention a question which has arisen in regard to section 817(h)(3) of the Code. Section 817(h)(3), as added by the 1984 Act, provides that, irrespective of the diversification regulations to be promulgated by the Service pursuant to paragraph (1) of section 817(h), a variable life insurance contract may be based on a segregated asset account which is fully invested in securities issued by the United States Treasury. A question arose after enactment of the 1984 Act as to whether this exception for variable life insurance contracts would be available if the account was not "fully" invested in Treasury securities. For example, would the section 817(h)(3) exception be available if the separate account invested 99% in Treasury securities.

Section 121(l)(1) of the Technical Corrections Act would resolve this "fully" invested issue. However, read literally, the language in section 121(l)(1) would seem to permit a separate account which invests any amount in Treasury securities to be deemed adequately diversified, irrespective of other investments of the account. For example, under the proposed language, the entire separate account might be considered adequately diversified even if it invests only 1% assets in Treasury securities. Obviously, this was not intended. Section 817 clearly requires that the entire account be adequately diversified, and not just a portion of it. Thus, the other investments of the account should still be required to meet the diversification standards prescribed by regulations or the safe harbor in order for those assets, and in turn the entire account, to be treated as adequately diversified.

Section 72(s) of the Code

Section 72(s) of the Code, as added by the 1984 Act, provides that an annuity contract must contain certain rules for distribution of the contract's values in the event of the contractholder's death. Section 126(a) and (b) of the Technical

Corrections Act of 1985 would amend section 72(s) of the Code so as to clarify a number of ambiguities which have arisen in connection with these so-called "distribution-at-death" rules. These amendments go a long way towards resolving some of the uncertainties in the 1984 Act. However, a number of questions still remain which we would like to bring to the Committee's attention.

1. Treatment of Section 403(b) Annuities.

As noted above, under section 72(s) of the Code, an annuity contract will not be treated as such for tax purposes unless the contract contains provisions requiring certain distributions in the event of the holder's death. Section 401(a)(9) of the Code contains similar distribution-at-death rules governing trusteed and non-trusteed qualified plans. In addition, section 401(a)(9) imposes before-death distribution rules on such contracts. Under these rules, a distribution is required generally beginning April 1 of the calendar year following the year in which (1) the employee attains age 70 1/2 or (2) the employee retires, whichever is later. Section 72(s) does not contain any such before-death distribution rules.

After the 1984 Act, a question arose as to which distribution-at-death rule applied in the case of a section 403(b) annuity -- section 72(s), section 401(a)(9), or both? The Technical Corrections Act would resolve this issue by providing in sections 126(a) and 152(a)(3) of such Act that section 403(b) annuities are not subject to section 72(s), but are covered by section 401(a)(9) of the Code. By subjecting section 403(b) annuities to the requirements of section 401(a)(9), the bill would impose before-death distribution requirements on such contracts. Addition of such a requirement is a major change in the law and should not be part of a technical corrections bill.

Furthermore, if enacted, this proposal would impose a substantial administrative burden on insurers. As proposed, section 152(a)(3) would be applicable to contributions made after the date of enactment of the Technical Corrections Act. Thus, for existing contracts, an insurer would be required to separate each person's cash value into portions representing contributions received before the effective date of the Technical Corrections Act and contributions received after the effective date of the Act. At a minimum, a change of this nature should not apply to existing contracts. Companies should be given sufficient time to amend their contracts and refile such contracts with the applicable authorities. For example, when Congress added the section 72(s) distribution requirements in 1984, it made them applicable only to contracts issued six months after date of enactment of the 1984 Act.

There is no evidence in the legislative history of the 1984 Act to indicate that section 401(a)(9) would be applicable to section 403(b) annuities. In fact, other provisions of the 1984 Act indicated that such contracts should be governed by section 72(s). Hence, many companies assumed that section 403(b) annuities would be subject to the rules of section 72(s), and amended their contracts to comply with those rules. Therefore, we urge the Committee to amend sections 126(a) and 152(a)(3) of the Technical Corrections Act to provide that section 72(s) of the Code, and not section 401(a)(9), will apply to section 403(b) annuities.

2. Special Rule for Individuals Holding In Representative Capacity.

Section 126(b)(1) of the Technical Corrections Act would amend section 72(s) of the Code so as to clarify the application of the distribution-at-death rules where the contractholder is not an individual. Under the proposed amendment, a "look-through" rule would be applied so that the primary annuitant would be treated as the holder of the contract, for purposes of section 72(s), if the contractholder is not an individual. While this amendment would resolve the issue of how section 72(s) is to apply where the holder of the contract is a corporation, it does not address the treatment of holders who are individuals but are acting only in a representative capacity, such as custodians or trustees. In order to resolve this problem, it is suggested that the language in proposed new Code section 72(s)(6)(A) be amended so as to extend the non-individual holder rule to include such individuals. As amended, the paragraph would thus provide that, if the contractholder is not an individual or is an individual acting in a representative capacity, the primary annuitant will be treated as the holder of the contract for purposes of section 72(s).

3. Gratuitous Transfers of Annuity Contracts.

Section 126(b)(1) of the Technical Corrections Act would amend section 72(s) of the Code by adding a new paragraph relating to the treatment of certain transfers of ownership of an annuity contract. Under the provision, if an individual who holds an annuity contract transfers such contract by gift, such transfer will be treated as the "death of the holder," thus forcing the entire interest in the contract to be distributed to the designated beneficiary under the contract. The identical rule would apply to a change in the primary annuitant in the case of a contract where there is a non-individual holder.

This proposed amendment is a substantive change in existing law and as such should not be included in a technical corrections bill. Furthermore, equating gratuitous transfers of annuity contracts with the death of the holder of the contract raises a number of technical questions which should be thoroughly explored before any action is taken. A simple example illustrates how this proposed amendment may go well beyond its intended result. Assume that individual holder X transfers, by gift, his deferred annuity contract to Corporation Y. Under the terms of the contract, X is the annuitant and upon X's death, his son S is to be the beneficiary of the contract. Thus, after the transfer, Corporation Y will be the holder of the contract, X will be the "primary annuitant," and S will be the beneficiary. If the proposed amendment is adopted, the transfer of the contract to Y will trigger a distribution of the contract's values to S. This will occur even though (assuming the other amendments in section 126(b) of the Technical Corrections Act are adopted) X is, for section 72(s) purposes, the "holder" of the contract both before and after the gratuitous transfer.

In its pamphlet describing the provisions of the Technical Corrections Act of 1985, the staff of the Joint Committee on Taxation indicated that the gratuitous transfer/distribution-at-death amendment was needed to ensure that individuals do not "avoid" the section 72(s) rules and continue deferral beyond the life of an individual taxpayer. If a problem of this nature does exist, we believe that there are more appropriate means of addressing the issue. For example, consideration should be given to amending section 72(e)(4)(A) of the Code (relating to loans or assignments of annuity contracts) to cover such gratuitious transfers.

At this time, we urge the Finance Committee to delete the gratuitous transfer provision in section 126(b)(1) of the Technical Corrections Act of 1985. If the Committee nonetheless decides to restrict gratuitous transfers or changes in primary annuitants, it is critical that an exception for changes or transfers to surviving spouses (similar to that in section 72(s)(3) of the Code) be provided.

Section 72(q) of the Code

Under section 72(q) of the Code, as added by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), a five percent penalty tax is imposed on certain premature distributions from an annuity contract. However, the Code goes on to provide, in paragraph (2) of section 72(q), that certain specified distributions from an annuity contract will not be subject to the penalty tax. A number of questions have arisen as to the applicability of these exceptions to corporate taxpayers and as to the interaction of these exceptions with the new distribution-at-death rules in section 72(s).

1. Death of the Annuitant.

Section 126(c) of the Technical Corrections Act would resolve a problem which developed as a result of the potential interaction of the distribution-at-death rules in section 72(s) of the Code and the five percent penalty tax in section 72(q) of the Code in the situation where the holder and the annuitant are not the same person. Under current law, because there is no exception in section 72(q)(2)(B) of the Code for distributions made upon the death of the holder, a beneficiary may be forced to pay a penalty tax on a distribution that was made solely because of the requirements of section 72(s) of the Code. The Technical Corrections Act would amend section 72(q)(2)(B) so as to provide that the penalty tax would not apply to any distribution made on or after the death of the holder or, where the holder is not an individual, the death of the primary annuitant.

However, in solving the distribution-at-death/penalty tax exception problem, the bill would create another problem in that the proposed amendment would delete the exception in current law for distributions made on or after the death of the annuitant. Thus, as of January 19, 1985, if a distribution were made under an annuity contract (in which the holder and the annuitant are two separate individuals) because of the death of the annuitant, the beneficiary may be forced to pay the penalty tax. Imposition of the penalty tax on a distribution made because the measuring life (*i.e.*, the annuitant) under the contract has died is unwarranted and is contrary to the original purpose of the penalty tax. The penalty tax was enacted in 1982 in order to prevent "premature" distributions from annuity contracts and thus to ensure that such contracts are not used as short-term investment vehicles. Clearly, providing an exception for distributions made because the measuring life under the contract has died in no way defeats this objective.

In order to avoid this result, the Committee of Annuity Insurers requests that section 126(c) of the Technical Corrections Act be amended so as to ensure that the penalty tax will not apply in the case of distributions made pursuant to section 72(s)[the distribution-at-death rules] or made upon the death of the annuitant.

2. Application of Penalty Tax Exceptions to Corporate Taxpayers.

As noted earlier, section 126(b)(1) of the Technical Corrections Act would amend section 72(s) of the Code so as to provide that the primary annuitant will be treated as the holder of the contract if the contractholder is not an individual. Under section 126(c) of the Technical Corrections Act, this same "look-through" rule would also apply for purposes of section 72(q)(2)(B) of the Code. Section 72(q)(2)(B), as amended by this bill, would exempt from the penalty tax distributions made upon the death of the contractholder or in the case of a non-individual holder, distributions made upon the death of the primary annuitant. However, the bill fails to address the issue of whether this same "look-through" rule should apply to the other exceptions from the penalty tax in section 72(q)(2). For example, in section 72(q)(2)(A), a distribution made on or after the taxpayer attains age 59 1/2 will not be subject to a penalty tax. If the "taxpayer" is a corporation, it is unclear how this exception can be applied. A similar issue arises under the exception for distributions made due to the disability of the taxpayer (section 72(q)(2)(B)) and the exception for distributions of substantially equal periodic payments over the life of the taxpayer (section 72(q)(2)(D)).

In order to resolve the questions which have arisen since enactment of TEFRA as to the applicability of these provisions in the case of the corporate taxpayer, the Committee of Annuity Insurers recommends that the Finance Committee amend S. 814 so as to apply the "look-through" rule to all of the penalty tax exceptions in section 72(q)(2) of the Code. The proposal to extend the "look-through" rule to individuals acting in a representative capacity should also be incorporated in the amendments to section 72(q).

Conclusion

The Committee of Annuity Insurers again wishes to thank the Committee on Finance for this opportunity to comment on S. 814, the Technical Corrections Act of 1985. We commend the Committee and its staff for their efforts to resolve a number of the technical issues which have arisen since enactment of the 1984 Act and respectfully request that the additional amendments which we have proposed be incorporated in any technical corrections legislation reported by the Finance Committee.

Coopers
&Lybrand

certified public accountants

1800 M Street NW
Washington D.C. 20036

telephone (202) 822-4000
twx 710-822-0140
cables Colybrand

in principal areas of the world

WRITTEN STATEMENT

Ira H. Shapiro
Director of Tax Policy
Coopers & Lybrand

Hearings Before the Senate Committee on Finance
June 11, 1985
on
Technical Corrections Act of 1985 (S. 814)

Mr. Chairman and Members of the Committee on Finance, I am pleased to offer our comments on S. 814, the Technical Corrections Act of 1985, as part of the ongoing process of resolving questions and problem areas in the Tax Reform Act (TRA) of 1984. I am Ira Shapiro, Director of Tax Policy for Coopers & Lybrand, an international accounting firm with 90 offices in the U.S. alone. I am submitting this statement on behalf of my firm.

My statement addresses only the more important matters that have come to our attention in the 1984 legislation. In addition, our statement includes a discussion of an issue from the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 which has recently come to our attention. We believe it is a matter that deserves the Committee's expeditious consideration in the context of this bill.

What follows is a brief description of each of the issues we believe should be addressed in this year's technical corrections legislation, organized by the 1984 Act section. The first item is the matter from the 1982 Act which we believe should also be included in the bill.

TEFRA of 1982, Act §201(b), Items of Tax Preference:

In TEFRA, the items of tax preference were expanded to include research and experimental (R&E) expenditures under §174. The preference amount is defined as the difference between the amount deducted under §174(a) and the amount if amortized ratably over a 10-year period. However, this preference is among those that do not apply to corporations other than personal holding companies. What was not well understood at the time of TEFRA is that the definitional aspects of the personal holding company (PHC) rules under Code §§542 and 543 are applying with increasing frequency to high-technology companies in the start-up and developmental stages of their business.

These companies often have narrow ownership and operate without significant revenues during their first few years. Because of earnings on invested capital prior to its use in the business, a company with little other income can technically fall under the PHC rules during the start-up period. Ironically, the company would not be subject to the PHC tax in these early years since it has no taxable income, and it would not be a PHC in the later years when it has substantial operating income. However, its classification as a PHC for the loss years causes a minimum tax problem. Under the TEFRA change, 90% of the R&E expenses will now be subject to the add-on minimum tax of 15%, although payment is deferred until the company becomes profitable.

Because of this deferred payment feature and the indirect application of the tax to high-technology companies, the nature of the problem has just begun to surface during this tax filing season. We do not believe that Congress intended to subject these sorts of active companies to a minimum tax on their R&E expenditures. Such a tax amounts to a penalty on start-up companies not borne by more established firms. We recommend that this problem be corrected retroactively in order to alleviate any deferred tax liabilities that may have accrued in 1983 and

1984. Proposed legislation by Congressman Pete Stark, H.R. 2528, would achieve this result by providing that R&E expenses under §174 are not to be considered a tax preference item for any corporation, including personal holding companies (copy attached). We hope the Committee will see fit to expand the bill to include this correction to TEFRA in order that it can be enacted expeditiously.

1984 TRA §75(b), Distributions of Partnership Interests Treated as Exchanges:

Section 75(b) of the 1984 Act added a new Code §761(e) which provides that a distribution shall be treated as a sale or exchange for purposes of §§708 (relating to continuation of a partnership), 743 (relating to the optional adjustment to the basis of partnership property), and any other provision of Subchapter K of the Code that is prescribed by the Secretary.

The proposed Technical Corrections Act clarifies that §761(e) only applies to distributions of partnership interests. We believe that §761(e) should be further clarified to indicate that any distribution of a partnership interest to an estate or heir caused by the death of a partner should not be treated as a "sale or exchange" for purposes of §761(e).

Under the literal language of §761(e), the death of a partner owning 50% or more of a partnership could cause a termination of the partnership with several adverse tax effects to the remaining partners (e.g., investment tax credit recapture). Clearly, death is not a tax planning tool in most partnerships, and a penalty should not be imposed on the remaining partners because of the death of a partner.

1984 TRA §79, Allocation of Certain Liabilities to Limited Partners:

Act §79 overturns the holding of the Raphan case. The legislative history on the intended effective date for this change is quite confused. The House Committee report cites an effective date rule of "amounts paid or incurred after March 1, 1984," while the conference report implies that transactions prior to March 1, 1984 would not be affected by the legislative change. The General Explanation by the Joint Committee on Taxation does not clarify the Congressional intent but adds more confusion by including a parenthetical reference to losses accrued on or after March 1, 1984.

Even though Raphan has been subsequently reversed on appeal, the decision of the appellate court seems to indicate that the legal premise expressed by the lower court -- that a partner can deal with the partnership "other than in his capacity as a partner" -- was accepted. Therefore, it remains important for the Committee to clarify the intended effective date of the provision.

Since Raphan deals with the borrowing of money by a partnership which is guaranteed by the general partner, we believe the effective date should be clarified to apply to loans incurred or guaranteed after March 1, 1984.

1984 TRA §147, Due Date of Individual Retirement Account Contributions:

In Act §147, the due date of April 15 was statutorily imposed for all IRA contributions without regard to extensions for the filing of individual tax returns (Code §219(f)(3)(A)). In making this change, it does not appear that any consideration was given to the plight of U.S. citizens residing abroad. Under current regulations, these taxpayers are granted an automatic two-month extension to file their tax returns, until June 15 (Reg. §1.6081-2(a)(5)). This rule recognizes the geographic and communication difficulties involved and the fact that most of these citizens do not even receive their W-2's until February 28 (Reg. §31.6051-1(d)(2)).

We believe that U.S. citizens residing abroad should be allowed to make IRA contributions until the extended due date of their returns, June 15. We have raised this issue with the Department of Treasury and with Congressional staff; a copy of our most recent correspondence on this issue is attached. In brief, we believe these taxpayers are at a disadvantage compared to U.S. residents in that they receive their W-2's late and will often not even know what their earned income is for tax purposes until the W-2 is received and the adjustments under Code §911 are subsequently calculated.

It is small solace that, if these taxpayers inadvertently make excess contributions to their IRAs, they can withdraw the excess without penalty up until the return due date. This solution is one that forces this group of taxpayers to accept lower yields on their IRA savings by foreclosing longer term investments. It also subjects them to some inevitable degree of aggravation as they attempt to withdraw or reallocate any excess amounts. We hope the members of this Committee will reconsider the requirement of an April 15th deadline for this group of taxpayers, in light of the hardship it could impose and the slight effect it would have on the original purpose for the rule.

1984 TRA Title VIII, §801(a):

Title VIII of the 1984 Act establishes new rules to govern the formation and operation of Foreign Sales Corporations (FSCs) to replace Domestic International Sales Corporations (DISCs) and includes a number of provisions to govern the phase-out of existing DISCs, the utilization of interest charge DISCs, and other transition issues. As a result of the interaction of a number of these rules, it has come to our attention that potential problems can arise when a company with a FSC acquires or merges with another company that has an interest charge DISC. A literal application of the statutory rules would result in a failure to meet the FSC definition because of the prohibition against having an interest charge DISC and a FSC in the same corporate group "at any time during the taxable year" (Code §922(a)(1)(F)).

The consequence of failure to meet the FSC definition appears to be a loss of the FSC tax benefits for the entire year. In addition, it appears that the interest charge DISC would be terminated as well. It is not at all clear that the Congress anticipated the problem outlined above or intended the results that appear to follow as a result of a merger involving a FSC and an interest charge DISC. The penalties certainly seem disproportionate to the event, and we believe the Committee's further consideration is warranted. One potential solution would be to allow some period of time in these circumstances for the target company to revoke its interest charge DISC election.

In a similar situation, where a company having a large FSC merges with another having a small FSC, the statute now appears to result in the loss of the tax benefits from the small FSC for the entire taxable year (Code §922(b)(2)). Again, we call this matter to your attention in the event the result was unintended and warrants further consideration as to alternative solutions.

This concludes my testimony. If the Committee has any additional questions about this matter, please feel free to contact me at 822-4232.

Coopers
&Lybrand

certified public accountants

400 Renaissance Center
Detroit Michigan 48243

telephone (313) 446-7100
twx 810-221-1690
cables Colybrand

in principal areas of the world

March 27, 1985

Mr. Ronald A. Pearlman
Assistant Secretary for Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Room 3120
Washington, D.C. 20220

Mr. Fred T. Goldberg, Jr.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Suggested Regulations for Section 147 of TRA of 1984: Due Date of IRA Contributions

Dear Messrs. Pearlman and Goldberg:

On October 31, 1984, I submitted a letter on behalf of Coopers & Lybrand which discussed the effects of Section 147 of the 1984 Tax Reform Act on U.S. citizens residing abroad. Due to the unique circumstances facing this group of U.S. taxpayers, we requested that the regulations provide U.S. taxpayers living abroad until June 15 to make their IRA contributions, since June 15 is actually the due date for filing these returns under Reg. 1.6081-2(a)(5). In support of this interpretation, we cited a number of other instances where administrative considerations have lead to delayed filing dates for this group of taxpayers. Also, we described the interactions of different tax provisions which complicate these returns.

Recently, in making an inquiry about the status of the proposed regulations in this area, we learned that there is reluctance on the part of some to provide an extended IRA contribution date for U.S. citizens residing abroad. Evidently, there are those who argue that unless the April 15 date is applied to all taxpayers, the administrative and enforcement posture of the IRS will not be significantly improved. Others seem to feel that taxpayers in the U.S. may have similar difficulties and thus relief should not be accorded any group of taxpayers. Further, it is argued that the ability of taxpayers to withdraw any excess contribution before the extended due date of the return, without penalty, adequately addresses the problems faced by this group.

To briefly respond without reiterating all the arguments made in our October 31, 1984 letter, U.S. citizens residing abroad do face unique and difficult circumstances which warrant separate consideration. This fact has been recognized throughout the regulations in developing administrative procedures and filing dates for these taxpayers. Further, it is not easy to fathom a case where a taxpayer resident in the U.S. will not know what his or her earned income will be for the year by the following January 31st. In contrast, taxpayers abroad will not even receive W-2's until after February 28 and still must compute the adjustments under Section 911 to determine what their earned income was for tax and IRA purposes. Indeed, allowing these taxpayers some additional time is not providing them special treatment but, rather, is addressing the disadvantage these taxpayers have in comparison with U.S. based taxpayers.

Secondly, the argument that IRS administrative and enforcement procedures will be hampered if any group of taxpayers is allowed a later contribution date seems an exaggerated concern. Returns of these taxpayers are readily identifiable and are all processed at one service center, providing an easy means of segregating these returns for separate compliance tests, if necessary. It would seem that any other problems presented could be addressed through changes to the 1099 filing requirements or processing techniques. It seems possible that the financial institutions involved might even agree to expedite these 1099 filings in order to avoid the paperwork and other problems involved when the taxpayers making contributions must often withdraw them later.

Finally, we would urge that the hassle factor for these taxpayers warrants some consideration. Obviously, these savers will not be able to invest in long term IRA accounts because if adjustments are necessary to the amounts contributed, a penalty for premature withdrawal will be imposed by the financial institution. Some affected taxpayers will make this mistake and in effect will pay a penalty. All will be forced to accept lower yields on their IRA savings. Further, the process of withdrawing or reallocating amounts that turn out to be excess contributions will cause many difficulties with the personnel of financial institutions. These personnel will not usually be aware of the statutory rules providing that these amounts should not be reported as premature withdrawals or excess contributions if adjustments are made before the extended due date.

In conclusion, we believe the goals of sound tax administration are better served by providing that U.S. citizens residing abroad may make IRA contributions until June 15, the due date of their returns under Reg. 1.6081. If you have any further questions, please call me at 313/446-7339, or Ira Shapiro or Pam Pecarich in our Washington office at 212/822-4235.

Very truly yours,

John T. Heitmann

John T. Heitmann
Director, Services to Executives Abroad

cc: David Brockway
Chief of Staff
Joint Committee on Taxation

Harry Conaway
U.S. Department of Treasury
Office of Tax Legislative Counsel

I

99TH CONGRESS
1ST SESSION

H. R. 2528

To amend the Internal Revenue Code of 1954 to provide that research and experimental expenditures of corporations, including personal holding companies, shall not be treated as items of tax preference for purposes of the minimum tax.

IN THE HOUSE OF REPRESENTATIVES

MAY 15, 1985

Mr. STARK introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to provide that research and experimental expenditures of corporations, including personal holding companies, shall not be treated as items of tax preference for purposes of the minimum tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the last sentence of section 57(a) of the Internal Revenue Code of 1954 (defining items of tax preference) is amended by inserting before the period at the end thereof the following: "and paragraph (6) to the extent it relates to the deduction under section 174(a) also shall not apply to a personal holding company (as so defined)".

(b) The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1982.

TESTIMONY OF

LOUIS J. GAMBACCINI

ASSISTANT EXECUTIVE DIRECTOR/DIRECTOR OF ADMINISTRATION

THE PORT AUTHORITY OF NEW YORK AND NEW JERSEY

ON BEHALF OF

DALLAS AREA RAPID TRANSIT
NEW JERSEY TRANSIT CORPORATION
SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY
TRI-COUNTY METROPOLITAN TRANSPORTATION
DISTRICT OF OREGON

ON the TECHNICAL CORRECTION ACT of 1985, H.R. 1800

BEFORE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
MAY 29, 1985

TESTIMONY OF
LOUIS J. GAMBACCINI
ASSISTANT EXECUTIVE DIRECTOR/DIRECTOR OF ADMINISTRATION
THE PORT AUTHORITY OF NEW YORK AND NEW JERSEY

ON THE TECHNICAL CORRECTION ACT of 1985, S. 814
BEFORE
COMMITTEE ON FINANCE
UNITED STATES HOUSE OF REPRESENTATIVES
MAY 29, 1985

Mr. Chairman and members of the Committee, thank you for the opportunity to submit written testimony for your consideration during deliberations on the Technical Correction Act, S. 814. This testimony is being submitted on behalf of the Port Authority of New York and New Jersey, New Jersey Transit, Dallas Area Rapid Transit, Southeastern Pennsylvania Transportation Authority and Portland's Tri-County Metropolitan Transportation District of Oregon (Tri-Met).

Last year,as part of this Committees consideration of the Deficit Reduction Act of 1984, it adopted the House Ways and Means Committees Report language allowing employers to provide employees with a de minimis fringe benefit of $15 per month for commutation by public transit. This testimony will focus on the need to clarify and broaden the Report text in two ways:

- permit employers to assist employees with the actual cost of commuting by public transit; and
- clarify the administrative format, which could be interpreted to limit the benefit to the distribution of discounted passes or tokens, to include other mechanisms such as vouchers or reimbursements.

Our reasons for recommending changes to the current description of the public transit fringe benefit follow. We believe that they are consistent with the Committee's original intent to assist us in reducing automobile congestion during peak commuting hours and in maximizing transit ridership by involving businesses in promoting public transit.

Transit in our regions serves over one-third of the nations' public transit commuters. The New York/New Jersey Metropolitan Region alone accounts for nearly half of the country's annual miles of public transit travel. New Jersey Transit (NJ Transit) operates 380 route miles of commuter rail, 4.1 miles of light rail and 1800 buses to carry an average weekday patronage of over 100,000 people into the New York Metropolitan area. The Port Authority operates all the transportation facilities between New Jersey and New York across the Hudson River with the exception of the Amtrak line into Pennsylvania Station. Its interstate rapid transit service, PATH, carries about 200,000 daily riders primarily into Manhattan from New Jersey. The Dallas Area Rapid Transit (DART) operates 764 buses serving a daily patronage of 176,000 passengers. Portland, Oregon's Tri-Met serves 124,000 daily passengers on its 625 buses. In addition, Tri-Met will open its new 18 mile light rail line in 1986 which is designed to carry 40,000 people a day. SEPTA (Southeastern Pennsylvania Transportation Authority) serves the Philadelphia metropolitan area. Their services transport almost 1 million daily passengers on buses, trolley, subway, elevated lines and commuter rail lines. SEPTA operates over 2,500 vehicles on 150 routes covering 3,900 route miles.

- Equity

All of the urban areas served by our agencies experience auto congestion during the peak commuting hours. We have all been attempting to provide attractive alternatives to commuting by autos. However, many autoists are provided financial incentives by employers for commuting by auto. Last year, the Port Authority conducted indepth surveys of all autoists using its three main vehicular facilities from New Jersey into Manhattan across the Hudson

River. The surveys revealed that 64 percent of the daily auto commuters who travel into the Central Business District of Manhattan receive full or partial employer subsidies. In fact, more than 2 out of every 10 of these auto commuters are fully subsidized. The total value of these auto subsidies can be worth as much as $600 per month to commuters. For those receiving a partial subsidy, free parking is most common. Over half (54%) of these auto commuters receive subsidized parking in Manhattan where monthly parking costs run as high as $200 in the downtown area and $300 in the midtown area.

Alternatively, public transit expenses in certain regions like the New York area, are substantially less than auto commuting costs (including parking). Thus, the relative impact of the $15 transit benefit is far less than that available to autoists. New York subway riders pay $36 a month to commute, while suburban commuters or those living in the boroughs other than Manhattan using express buses, pay an average of $100 per month. Nationally, the average monthly cost of commuting by public transit is less than $50 excluding suburban commuter rail and express bus systems. Overall, the average monthly cost is less than $75 per month. In order to offset the disparity between auto-related employer provided fringe benefits and the present public transit fringe benefit, we believe that raising the benefit to the actual cost of commuting by transit would establish a reasonable parity between auto and transit employer provided benefits.

- Marketing

Clarify Administrative Procedures

NJ Transit along with the Port Authority and the MTA have begun to develop program options to offer the public transit benefit to employers in the New York Metropolitan area. However, the diversity of public transit services in this region and the different fare systems employed by each agency creates a potentially burdensome situation for employers. For example, the MTA subways employ tokens, and buses accept tokens or cash; the suburban railroads operated by the LIRR, Metro-North, and NJ Transit Rail Corporation use different types of monthly passes and multi-ride tickets; and the Port Authority's PATH system accepts only cash. Therefore, limiting employers to the distribution of reduced cost passes and tokens will dictate a major administrative and financial effort requiring employers to work with at least four separate agencies to arrange for the monthly delivery of tokens and an assortment of passes. Furthermore, users of PATH and numerous private bus services would be totally excluded from the benefits of this program since no passes or tokens are available.

Considering that the public transit fringe benefit is a de minimis benefit, employers and transit agencies require more flexible administrative procedures to allow for the development of program options which minimize the administrative burden on employers. The proposed changes will fulfill these requirements. Where sale of discounted passes or tokens are practicable, the local transit authority will furnish employers with these tickets or tokens for redistribution on a discounted basis, and will recommend procedures against transferability. Where variable cost tickets or non-ticketed services are involved, it is clearly not feasible to rely on selling discounted tickets to employers. Instead, a system is being devised under which the employee can be reimbursed upon proof of purchase of the ticket or usage of the service. As an alternative, consideration is also being given to developing a voucher for distribution to employees which can be redeemed at the time an employee purchases a commutation ticket.

Increase Fringe Benefit

Our other transit agencies, DART, Tri-Met and SEPTA, are able to offer discounted passes or tokens as the main means to provide the new public transit fringe benefit. But the size of the benefit compared with auto-related fringe benefits being offered reduces the attractiveness of public transit for those commuters who are able to use either mode. Current employer pass programs being marketed by these three agencies would be enhanced by allowing employers to assist employees with the actual cost of commuting by public transit and on a par with auto-related benefits. As indicated earlier, suburban commuters often pay $100 or more each month to commute by public transit. Increasing the benefit to cover these actual costs will provide an important incentive to autoists to switch to transit and help retain existing transit ridership.

o Private Participation

Transit agencies such as ours are working to involve the private sector in meeting the transportation needs of urban areas. Given the limited capacity of existing roads to accommodate the number of employees who work in urban areas, our transit systems provide a critical link in the regional transportation network. The new fringe benefit allows us to involve employers in the support and promotion of public transit, as an important and realistic alternative to auto commuting. Furthermore, given the present threat of reduced federal operating assistance, increasing the benefit to the actual cost of commuting will provide transit agencies with the ability to obtain private funding to offset some of the effects of federal assistance reductions. Additionally, the employer program supports Congress' and the Administration's desire to encourage private participation in such public endeavors as mass transit.

Our recommended language to increase the de minimis employer transit fringe benefit and allow for vouchers and reimbursements will provide greater equity for transit users, enhance transit marketing and increase employer involvement in transit.

At a time when the country needs to optimize its public investment, it is critical that we enhance the efficiency and productivity of our transportation systems. In urban areas, increased transit usage as opposed to increased auto usage will maximize that investment.

Therefore, we strongly urge you to adopt our recommendations. Thank you again for the opportunity to submit testimony.

DUCKER, GURKO & ROBLE, P.C.
ATTORNEYS AT LAW
ONE CIVIC CENTER PLAZA
1560 BROADWAY, SUITE 1500
DENVER, COLORADO 80202
303-861-2828

BRUCE DUCKER
STEPHEN GURKO
TIMOTHY D. ROBLE
CHARLES F. DEWEY

MICHAEL J. KELLY

Please address reply to:
101 WEST MAIN STREET, SUITE 300
P. O. BOX B
FRISCO, COLORADO 80443
(303) 668-3776
WHEN CALLING FROM DENVER 674-1783

May 25, 1985

Mrs. Betty Scott-Boom
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mrs. Scott-Boom:

Enclosed are six separately signed copies of a written Statement filed for the printed record of the Committee's hearing on S. 814 (the Technical Corrections Bill of 1985) which is to be held on June 5, 1985.

Very truly yours,

Ducker, Gurko & Roble, P.C.

By
Stephen Gurko, Vice President

SG/kcp
Enclosures
Certified Mail - Return Receipt Requested

STATEMENT FOR SENATE FINANCE COMMITTEE HEARING ON S. 814, THE TECHNICAL CORRECTIONS BILL OF 1985

Topical Summary: The Tax Reform Act of 1984 (the "Act") provides for multiple trusts to be treated as one trust for tax purposes under certain circumstances. Section 106(a) of S. 814 (the "Bill") provides that this provision of the Act does not apply to a trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date. This Statement proposes that the date of March 1, 1984, be changed to July 18, 1984, which was the date of enactment of the Act.

Person Submitting Statement: Ducker, Gurko & Roble, P.C., a law firm with offices in Denver and Frisco, Colorado. The name, address and telephone number of the attorney representing the firm in this matter are: Stephen Gurko; Ducker, Gurko & Roble, P.C.; 101 West Main Street; P.O. Box B; Frisco, Colorado 80443; (303)668-3776. The firm is acting on behalf of certain trusts which are affected by Section 106(a) of the Bill. The names and addresses of those trusts will be provided on request.

Statement. The Act's and the Bill's provisions are sound public policy with respect to multiple trusts. It must be recognized, however, that the Act's provisions go well beyond the existing Treasury Regulations in regard to the circumstances in which multiple trusts may be treated as one trust for tax purposes. For example, the Act permits such treatment where tax avoidance is a principal purpose for the multiple trusts (not just where the multiple trusts lack a substantial non-tax purpose, which is the rule under the Regulations), and where the multiple trusts have substantially the same "primary" beneficiary (not just where they have substantially the same beneficiary, which is the rule under the Regulations). Therefore, application of the Act's provisions on a prospective basis only, as provided for in the Bill, is appropriate.

The Bill's proposed effective date of March 1, 1984, is too early a date to treat taxpayers as reasonably on notice of the Act's change in existing law. Although sometimes it is appropriate to specify the earliest Congressional committee announcement date as the effective date for a new tax provision, this approach is not appropriate in the present situation. The various individual grantors and trustees of trusts around the country cannot be expected to keep informed of potential legislative developments on a daily basis. Many new trusts were undoubtedly created, and new gifts made to existing trusts, after March 1, 1984, in reliance on existing law.

It is recommended that an effective date of July 18, 1984, be substituted for the proposed effective date of March 1, 1984, in Section 106(a) of the Bill. July 18, 1984, is the date of the Act's enactment, after which all taxpayers should be presumed to know about the Act's provisions. Alternately, an effective date before July 18, 1984, but after March 1, 1984, is recommended. A third alternative would be to retain the March 1, 1984, effective date as the general rule, but allow a later effective date (preferably July 18, 1984) for new trusts (or gifts to existing trusts) in circumstances where the Act but not the existing Regulations would require treatment of the trusts as a single trust.

Respectfully submitted on this 25th day of May, 1985.

Ducker, Gurko & Roble, P.C.

By Stephen Gurko
Stephen Gurko, Vice President

STATEMENT OF ECONOMICS LABORATORY INC.
ON THE TECHNICAL CORRECTIONS
TO THE DEFICIT REDUCTION ACT OF 1984

COMMITTEE ON FINANCE

JUNE 5, 1985

SUMMARY

Section 280G, Golden Parachutes, should be corrected to exclude the acquisition of closely-held corporations or those corporations whose stock is not publicly traded. Protection of shareholders in not required where the primary executive is the primary shareholder.

Economics Laboratory is a chemical specialty firm engaged primarily in environmental sanitation. We provide detergents and cleaning systems to a wide variety of commercial, industrial and institutional customers including hotels, restaurants and hospitals. We also have a consumer product line including the dishwashing detergents Finish and Electrasol, and other household products.

We wish to thank the Committee and in particular Senator Chafee and Catherine Porter for working with us and others over a period of several weeks to resolve technical problems in a new code section, IRC Section 280G, Golden Parachutes. We believe that Section 280G should not apply to the acquisition of closely-held corporations, nor to the acquisition of corporations whose stock is not publicly traded. We are led to our conclusions by oral and written legislative history, and by the specific language in the "blue book," p. 204 which refers only to large, publicly-held corporations.[1]

The purpose of Section 280G of the Code was to respond to the extraordinarily generous "golden parachute" employment contracts which certain executives in publicly-held corporations had received. These contracts enabled the executives either to prevent the sale of the corporation's assets or stock and thereby perpetuate their power, or, in the eventuality of a sale, to reap huge financial rewards. The executives in these publicly-held corporations generally were not major shareholders in the corporations and as a result of the benefits they received from their employment contracts were at the expense of the shareholders. Congress believed that limitations were appropriate so that executives would not benefit at the expense of the shareholders as a group.

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[1] "...Congress believed that in most large, publicly held corporations, top executives are not under-compensated." (Underlining supplied.)

The entire text of the section on "Reasonable Compensation," of which this sentence is the first, is attached.

Obviously, this is not a concern in a one-person corporation in which the executive is the sole shareholder. In such a case, there is a complete identity between shareholder and executive and the rules of Section 280G clearly should not apply. Nor should the rules apply in any other situation where the primary executives are also the primary shareholders. Congress was not attempting to write a law regulating the rights of shareholders vis-a-vis other shareholders, but rather, was attempting to limit an abuse where entrenched executives, who had no or only a minor stockholder interest, were attempting to receive large payments or to perpetuate their control at the expense of public shareholders.

We believe further that the application of Section 280G to the acquisition of closely-held non-publicly traded corporations will have an adverse effect on these acquisitions.

(1) We are concerned that the uncertainty with regard to the application of Section 280G may cause well-advised prospective purchasers to reduce the

amounts which they would otherwise pay in acquiring a business and thereby hinder the normal, arm's length voluntary negotiation of sales of closely-held corporations.

(2) We are also concerned that many prospective purchasers and sellers, who did not even consider the golden parachutes rules because they associated the concept only with publicly-held corporations, could be totally and justifiably surprised by the application of these rules by an IRS agent.

Although it is relatively easy to conclude that Congress did not intend to include closely-held corporations within the scope of Section 280G, it is somewhat difficult to define precisely a closely-held corporation. We have previously suggested to staff several alternative definitions:

1. A corporation whose stock is not readily tradable on an established securities market.
2. A corporation whose securities are not required to be registered under Section 12 of the Securities Exchange Act of 1934.
3. A corporation which satisfies the stock ownership rules in Section 542(a)(2).

4. A corporation with 35 or fewer shareholders.

5. A corporation where 50% or more of the shareholders consent to the acquisition.

Indeed, it is possible to combine these suggestions. For example, Section 280G(c)(1) could be amended by (i) adding after "corporation" the words "other than a closely-held corporation" and (ii) adding at the end of Section 280G(c)(1) the following sentence: "For purposes of this section, a closely-held corporation shall mean a corporation (i) which satisfies the stock ownership rules in Section 542(a)(2), (ii) which has 35 or fewer shareholders, and (iii) the stock of which is not readily tradable on an established securities market." We believe that such a definition would not be overly broad and at the same time would effectively exclude situations in which there is an identity between shareholders and executives.

Although one of our suggested alternatives involves the shareholder consent approach, it is our view for several reasons that this is the least desirable alternative. First, closely-held corporations and their shareholders are often the type of taxpayers who have the most difficult time following formalities, and another election should not be imposed on these taxpayers unless it is absolutely necessary. Second, larger, more sophisticated corporations, which are clearly not closely-held corporations, could, through an elaborate proxy campaign, obtain the necessary shareholder approval and thereby avoid the application of Section 280G. Third, the percentage of shareholders whose approval would be required would be a critical factor. In this regard, a 100% consent approach would be unworkable because it would incur so-called "hold-up" situations. For example, assume the sole owner of a small business grants the plant manager a 20% interest in the business and three years later the plant manager is terminated for cause. In such a situation, it is unreasonable to condition the application of the golden parachute rules on the consent of a former disgruntled employee.

If a consent requirement were thought to be necessary, it should be used only as an additional factor in defining closely-held corporations to ensure that closely-held corporations alone could utilize the exemption. In our view, any consent provision requiring approval by a majority of the shareholders is sufficient to reflect Congressional intent given the dual identity of the executives and shareholders. In any event, the percentage of shareholder approval should not be greater than the percentage required under the relevant state corporate statute governing extraordinary corporate matters, such as a sale of substantially all of the corporation's assets or adoption of a plan in complete liquidation.

In conclusion, Econ Lab is not involved in hostile takeovers of vulnerable corporations. Even the term "takeover" does not apply to our voluntary negotiations of the sale of regional corporations. Econ Lab is merely meeting the growth challenge of the 1980's through acquisition. Econ Lab hopes to become a national market leader in a second, related service activity as it is in cleaning systems. To continue growing we must acquire another line of business.

Until recently we did not realize that our acquisitions would trigger these corporate sanctions. We think it ludicrous that Econ Lab could be denied a legitimate business deduction for desiring to continue the employ of the previous shareholder-employee; and we understand that this is precisely the effect of IRC Section 280G. The shareholders of the businesses we are acquiring are able to protect themselves in a voluntary negotiation for their own stock and services. The golden parachute provisions were designed to protect minority shareholders but instead have placed an unnecessary restraint on the voluntary sale of closely-held or non-publicly traded corporations.

Thank you for this opportunity to share our concerns.

PATTON, BOGGS & BLOW
2550 M STREET, N. W.
WASHINGTON, D. C. 20037
(202) 457-6000

ITT TELEX 440324
TRT TELEX 197780
TELECOPIER 457-6315

WRITER'S DIRECT DIAL

June 7, 1985 (202) 457-5212

Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: Technical Corrections Act of 1985 (H.R. 1800) -- Original Issue Discount on Tax-Exempt Bonds

Dear Mr. Chairman:

This letter is submitted on behalf of our client E.F. Hutton & Co., Inc. for inclusion in the record of the Committee's hearing on the proposed Technical Corrections Act of 1985 (H.R. 1800). For the reasons set forth below, we urge the Committee to consider amending H.R. 1800 to provide that the provisions of the Tax Reform Act of 1984 relating to the treatment of original issue discount ("OID") on tax-exempt bonds will be applicable only with respect to obligations issued after December 31, 1982 (rather than September 3, 1982) and acquired after March 1, 1984.

Background. For many years, OID on a tax-exempt bond (i.e., the excess of the face value of the bond at maturity over the price at which it is orginally issued) was treated by the Internal Revenue Service as tax-exempt interest under section 103 of the Internal Revenue Code. In addition, the Service took the position in a published ruling (Rev. Rul. 73-112, 1973-1 C.B. 47) that OID on a tax-exempt bond was required to be apportioned on a straight-line basis among the original and subsequent holders (if any) of the bond. At the time Rev. Rul. 73-112 was issued, section 1232 of the Code applied the same ratable accrual method to OID on taxable bonds.

In the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Congress amended the Code to require use of a so-called "constant interest method" for calculating

OID on bonds issued after July 1, 1982 by corporations and certain other entities. Congress did not, however, explicitly amend the Code to prescribe comparable treatment for OID on tax-exempt bonds. Indeed, it is understood that, on July 12, 1982, the Senate Finance Committee removed tax-exempt bonds from the application of the new statutory rules. Moreover, the committee reports that comprise the official legislative history of TEFRA do not expressly state that Congress intended the TEFRA rules to be applied to tax-exempt bonds.

While there appears to have been some uncertainty in the private sector whether a similar change was to be "implied" for tax-exempt bonds, the Service did not revoke Rev. Rul. 73-112 and numerous issues of tax-exempt bonds (including so-called "zero coupon" bonds) proceeded on the basis that the ratable accrual method should continue to apply to tax-exempt bonds.

On December 31, 1982, the staff of the Joint Committee on Taxation issued its "General Explanation" of TEFRA, which included (at page 162) the statement that "Congress intended that the new nonlinear formula for accrual of OID also apply . . . in determining accrual on State and local bonds."

Tax Reform Act of 1984. In sections 41 and 43 of the Tax Reform Act of 1984, Congress added to the Code a provision (section 1288) a provision explicitly requiring the use of the constant interest method for OID on tax-exempt bonds. Under this statutory change, less tax-exempt interest would accrue early in the bond term and more would accrue later in the bond term, thus reducing the likelihood that the holder of a tax-exempt bond issued at a deep discount could claim a tax loss (while having an economic gain) by selling the bond before maturity. This statutory change was made on a partially retroactive basis, i.e., it was applied to bonds issued after September 3, 1982 (the date of enactment of TEFRA) and acquired after March 1, 1984.

Effective Date. The rationale for the retroactive effective date appears to have been that Congress "intended" the TEFRA rules to apply to tax-exempt bonds. However, as noted above, the first published statement to that effect did not appear until December 31, 1982, nearly four months after the date on which TEFRA was enacted. Although some may have anticipated that the TEFRA changes for taxable bonds might be taken implicitly to suggest a comparable change for tax-exempt bonds, the absence of any published statement to the effect until December 31, 1982 should be given great weight in setting the effective date for the 1984 changes.

* * *

For these reasons, we urge the Committee to consider amending H.R. 1800 to include a provision limiting the application of the referenced 1984 changes to tax-exempt bonds issued after December 31, 1982 and acquired after March 1, 1984.

Very truly yours,

Donald V. Moorehead

Donald V. Moorehead

DVM/llr

ERIC

The
ERISA
Industry
Committee

1726 M Street
Northwest
Suite 301
Washington, DC
20036
(202) 833-2800

June 5, 1985

STATEMENT OF THE ERISA INDUSTRY COMMITTEE REGARDING S. 814 THE TECHNICAL CORRECTIONS ACT OF 1985, AMENDING THE DEFICIT REDUCTION ACT OF 1984 AND OTHER RECENT LEGISLATION, SUBMITTED TO THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

The ERISA Industry Committee ("ERIC") is a non-profit association of over one hundred major corporations doing business in a wide variety of American industries. ERIC's members maintain pension and welfare plans for millions of participants and beneficiaries. ERIC's views are representative of a broad cross-section of major plan sponsors in the private employee benefits community.

Recommended Changes

ERIC recommends that the following changes be made in S. 814:

§ 107(b). Section 107(b) amends I.R.C. § 467(g) to make clear that it does not apply to any amount to which § 404 or § 404A (or any other provisions specified in regulations) applies. This amendment is appropriate and needed. However, it should be expanded to refer to §§ 83, 419, and 463. Like §§ 404 and 404A, §§ 83, 419, and 463 provide specific rules limiting an employer's ability to deduct expenses associated with various forms of employee benefits. There is no reason to apply section 467(g) to expenses already covered by these provisions.

§ 151(a)(2)(B). Section 151(a)(2)(B) amends I.R.C. § 419A(d)(1) to provide that it applies to the first taxable year for which a reserve is taken into account under § 419A(c)(2) and to all subsequent taxable years. The Joint Committee Staff's explanation of this amendment indicates (at p. 83) that its purpose is to make clear that the separate accounting requirement with respect to post-retirement medical benefits and post-retirement life insurance benefits does not apply until the first taxable year for which a reserve is computed. The amendment states that § 419A(d)(1) applies to the first such year, but fails to state that it does not apply to prior years. The amendment should be clarified by the addition of the following phrase at the end of the amendment: "but shall not apply to any previous taxable year."

§ 151(a)(3)(A). Section 151(a)(3)(A) amends I.R.C. § 419A(e) to provide that no reserve may be taken into account for post-retirement medical benefits or life insurance benefits unless the plan meets the requirements of I.R.C. § 505(b), even though the requirements of § 505(b) do not apply to the plan. This amendment should be deleted from the bill; it makes a substantive change in the scope of § 505(b) that is inappropriate in a technical corrections bill.

§ 151(a)(11). Section 151(a)(11) amends I.R.C. § 4976(b) to extend the 100% excise tax imposed by § 4976 to a benefit provided under a plan that fails to meet the requirements of I.R.C. § 505(b), even though the requirements of § 505(b) do not apply to the plan. This amendment makes a substantive change in the scope of § 4976, and it is inappropriate for inclusion in a technical corrections bill. This aspect of the § 151(a)(11) amendment should be deleted from the bill.

Section 151(a)(11) also amends § 4976(b)(1) to make clear that the separate account requirement applies only to post-retirement benefits and only where a separate account is required by § 419A(d). This aspect of the amendment is appropriate, and should not be deleted.

§ 151(a)(12). Section 151(a)(12) adds a new paragraph (6) to § 511(e) of the Tax Reform Act of 1984. Paragraph (6) provides, in part, that the Tax Reform Act provisions expanding the application of the tax on unrelated business income are effective for taxable years ending after December 31, 1985. The effect of the amendment is to accelerate significantly the effective date of the Act's unrelated business income provisions. Section 511(e) now provides, in general, that the amendments made by § 511 (including those pertaining to the tax on unrelated business income) apply to contributions paid or accrued after December 31, 1985, in taxable years ending after that date. Although this provision is not well suited to the unrelated business income provisions, it clearly reflects the intention that § 511 should not apply until after

December 31, 1985. The proposed amendment would depart from that intention by accelerating the effective date to apply to unrelated business income arising during 1985 in fiscal years beginning in 1985. Because the amendment makes a significant, nontechnical change in the Act, it should either be deleted altogether or modified to eliminate the acceleration that it requires.

§ 152(b)(7). Section 152(b)(7) amends I.R.C. § 401(a)(20) to provide that a pension plan will not be disqualified under § 401(a) merely because it makes complete distributions to its participants on account of plan termination before the time when they otherwise would be eligible for distributions. Although this amendment appears to be appropriate, it should be expanded to provide that similar distributions under a terminated cash or deferred arrangement will not cause that arrangement to be disqualified under § 401(k). Since the § 401(k) restrictions on distributions were not intended to be more stringent than the § 401(a) restrictions for pension plans (and, in a number of respects, they are less stringent), it is appropriate to refer to cash or deferred arrangements in § 401(a)(20) as well as to pension plans.

§ 153(c)(2). Section 153(c)(2) amends I.R.C. § 4977 to provide that only employment within the United States will be taken into account in applying the excise tax on excess fringe benefits. A conforming change should be made in I.R.C. § 132(c)(2) to clarify that only the U.S. operations of an employer should be taken into account in calculating the gross profit percentage for purposes of the employee discount provisions. Virtually all employees who are subject to the employee discount provisions will be employed in their employers' U.S. operations. Thus, in calculating the gross profit percentage, it is appropriate to consider only U.S. operations. If foreign operations were considered, the often significant differences between U.S. and foreign economic conditions are likely to distort the results of the calculation. Moreover, the administrative burden of calculating the gross profit percentage on the basis of foreign operations would be disproportionate to the relatively small number of U.S. taxpayers employed overseas.

Recommended Additions

ERIC recommends that the following provisions be added to S. 814:

Funded Welfare Plans
(I.R.C. §§ 419, 419A, 512, & 4976)

1. The bill should make clear that post-retirement benefits may be funded at retirement (*i.e.*, under the terminal funding method), rather than over the working lives of the employees.

2. The bill should make clear that once medical care costs for retirees actually increase, the additional costs may be funded on a deductible basis (i) by making an additional lump sum payment, in respect of those already retired, and (ii) by making level payments over the remaining working lives of those still working.

3. The bill should make it clear that the adjustment required by I.R.C. § 419A(f)(7) is taken into account under I.R.C. § 512(a)(3)(E).

4. Paragraph (2) of I.R.C. § 4976(a) should be revised to make it clear that it applies only if a "welfare benefit fund" provides the disqualified benefit.

Group-Term Life Insurance
(I.R.C. § 79)

1. The bill should make clear that, consistent with the nondiscrimination provisions for pension plans, it is not necessary to aggregate all of an employer's group-term life insurance plans in determining whether a particular plan is discriminatory.

Employee Stock Ownership Plans
(I.R.C. § 404(k))

1. The bill should amend § 404(k) to make clear that where a plan gives each participant the option to receive current dividend distributions or to have dividends remain in the plan, the employer will be entitled to deduct those dividends that are distributed currently.

2. The bill should amend § 404(k) to make clear that where a plan distributes all of the year's dividends after the close of the year in a single distribution, any earnings on the dividends may be distributed at the same time, and the earnings (like the dividends) will be exempt from the pension withholding requirements.

Below-Market Loans
(I.R.C. § 7872)

1. The bill should make clear that when a lender is prohibited by local usury laws from charging interest at the applicable Federal rate, the loan will not be treated as a below-market loan.

Required Distributions
(I.R.C. § 401(a)(9))

1. The bill should clarify that a "designated beneficiary" under § 401(a)(9) may be (i) a spouse who is deemed to be so designated under §§ 401(a)(11) & 417, (ii) the alternate payee under a qualified domestic relations order, or (iii) a trust. The bill should also clarify that it is permissible for a participant to have more than one designated beneficiary, that the participant is not required to specify in advance the percentage interest of each beneficiary, and that the participant may allow a fiduciary to allocate the benefit under the plan among the designated beneficiaries. In addition, the bill should provide that if a trust is the beneficiary, the beneficiary's life expectancy is determined by reference to the life expectancy or expectancies of the beneficiary or beneficiaries of the trust.

Cash or Deferred Arrangements
(I.R.C. § 401(k))

1. The bill should revise I.R.C. § 401(k)(3) to provide that if the plan is maintained pursuant to a collective bargaining agreement, and satisfies the otherwise applicable requirements of I.R.C. §§ 401(a)(4) and 413(b)(2), it need not satisfy the actual deferral percentage test.

ERIC

The
ERISA
Industry
Committee

June 5, 1985

STATEMENT OF THE ERISA INDUSTRY COMMITTEE REGARDING H.R. 2110, AMENDING THE RETIREMENT EQUITY ACT OF 1984, SUBMITTED TO THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

The ERISA Industry Committee ("ERIC") is a non-profit association of over one hundred major corporations doing business in a wide variety of American industries. ERIC's members maintain pension and welfare plans for millions of participants and beneficiaries. ERIC's views are representative of a broad cross-section of major plan sponsors in the private employee benefits community.

Recommended Changes

ERIC recommends that the following changes be made in H.R. 2110:

§ 2(a)(1). To correct clerical errors, "are" should be changed to "is" on line 16, page 2, and line 25, page 3; a closing parenthesis should be added on line 19, page 2, immediately after "consecutive"; and the period should be change to a comma on line 11, page 4.

§ 2(a)(2). Section 2(a)(2) amends I.R.C. § 402(e) to provide that in determining whether a distribution that becomes payable on account of separation from service is a lump sum distribution, the balance to the credit of the employee will be determined without regard to any increase in vesting that may occur if the employee is re-employed by the employer; if the employee elects ten-year averaging with respect to the distribution and is later reemployed by the employer and his vested interest in his previously accrued benefits thereby increases, the tax benefits derived by the employee from his election of ten-year averaging are to be recaptured, and the prior election of ten-year averaging is to be disregarded in determining whether the employee may later elect ten-year averaging. The recapture approach would unduly complicate an already complex provision and should be deleted. The problem that the recapture approach addresses is adequately taken care of by the "look-back" rule of § 402(e)(2) and the only-one-election-after-age-59-½ rule of § 402(e)(4)(B). However, if the recapture provision is retained, it should be revised to make it clear that the

1726 M Street
Northwest
Suite 301
Washington, DC
20036
(202) 833-2800

prior lump sum distribution shall not be taken into account under the "look-back" rule. Since the benefits of ten-year averaging with respect to the prior distribution would already have been recaptured, it would be inappropriate to include the prior distribution in the look-back calculation.

§ 2(b)(2)(A)(ii) & (B)(ii). Section 2(b)(2)(A)(ii) & (B)(ii) amends the transferee plan rules of the Code and ERISA to provide that if separate accounts are maintained for the transferred assets "and any income therefrom," the transferee plan rules apply only to the transferred assets, and not to the other plan assets pertaining to the participant for whom the transfer was made. The amendment should be revised to replace "any income therefrom" with "any income allocable thereto" to avoid any suggestion that the transferred assets must be invested separately; the bill should require separate accounting, not separate investment. In addition, if it is intended to apply the transferee plan rules to both the transferred assets and the income allocable thereto, the amendment should also be revised to state that the rules will "apply only with respect to the transferred assets, adjusted to reflect any gains or losses allocable thereto" (new language underscored).

§ 2(b)(4). Section 2(b)(4) amends the survivor annuity provisions of the Code and ERISA to require a plan to provide that no portion of a participant's accrued benefit may be used as security for a loan without the consent of the participant's spouse. The terms of the amendment indicate that the spousal consent requirement will not apply to a plan (*e.g.*, a profit-sharing or stock bonus plan) that is exempt from the survivor annuity provisions by reason of I.R.C. § 401(a)(11)(B)(iii) & (C) and ERISA § 205(b)(1)(C) & (2). This is so because exempt plans are not subject to the provisions of I.R.C. § 417 and ERISA § 205 in which the loan provisions will appear. However, to eliminate any possible misunderstanding, the Committee's report should state explicitly that exempt plans are not subject to the loan provisions. (Any other result would make no sense, since a participant may make a withdrawal from an exempt plan without obtaining spousal consent.)

The amendments should also be revised to make it clear (i) *when* spousal consent must be given (presumably, when the security interest is given -- which is not necessarily at the same time that the loan is made), (ii) that, once given, a spouse's consent may not be revoked, and (iii) that a consent given by one spouse is binding on a subsequent spouse.

To correct a clerical error, "subsection (c)(1)(C)" should be changed to "subsection (a)(1)(C)" on line 6, page 11.

Section 2(b)(4) applies to loans made after April 18, 1985. This early effective date (the date on which H.R. 2110 was introduced) is unreasonable and should be postponed. Plan administrators cannot reasonably be expected to be able to comply with the new spousal consent provisions imposed by § 2(b)(4) as early as April 19, 1985. The effective date should give plan administrators a sufficient amount of time, after the bill is enacted, to learn about the new provision, to understand it, and to change their administrative procedures to comply with it. Accordingly, § 2(b)(4) should become effective no earlier than six months after the date of enactment of H.R. 2110.

§ 2(b)(5). Section 2(b)(5) amends I.R.C. § 417(a)(3)(B) and ERISA § 205(c)(3)(B) to extend the period for providing an explanation of the preretirement survivor annuity in the case of a participant who is hired after the close of the plan year preceding the plan year in which he attains age 35. In order to clarify its meaning, the amendment should be revised as follows: "in which the participant attains age 35, or, if the participant is hired after the close of the plan year preceding the plan year in which the participant attains age 35 (or within less than a reasonable period before such date), within a reasonable period after the participant is hired" (new language underscored).

§ 2(b)(6). Section 2(b)(6) amends the spousal consent requirements that govern an election to waive a survivor annuity by providing that either (i) the participant's election must designate a beneficiary that may not be changed without the spouse's consent or (ii) the consent of the spouse must permit the participant to designate beneficiaries without any requirement of further spousal consent. The amendment fails to address the common situation in which the participant's election involves no beneficiary at all -- for example, where the participant elects a single life annuity in lieu of a qualified joint and survivor annuity or where the participant declines the qualified preretirement survivor annuity and foregoes any preretirement death benefit under the plan. The amendment also does not specify whether, after the spouse has consented to the participant's election, the participant may change the form of the plan benefit without being required to obtain further spousal consent. These flaws could be remedied by revising the amendment to read, in part, as follows: "Such election designates a benefit option and, if applicable, a beneficiary, neither of which may be changed without spousal consent (unless the consent of the spouse permits changes in the benefit option, beneficiary, or both by the participant without any requirement of further consent by the spouse)".

The amendment should also provide that a plan may require either that all spousal consents must be restricted (i.e., limited to the particular benefit option and beneficiary (if any) elected) or that all spousal consents must be unrestricted (i.e., permitting subsequent changes without further consent by the spouse). This rule should be effective as of August 23, 1984. (If, contrary to our recommendation, a more restrictive rule is adopted, the new, more restrictive rule should apply only to consents given at least six months after the enactment of H.R. 2110.)

§ 2(c)(1). Section 2(c)(1) provides that where distributions are made to an alternate payee under a qualified domestic relations order, the distributions shall be included in the gross income of the alternate payee only where the alternate payee is the participant's spouse or former spouse; otherwise the distributions are included in the participant's gross income. This provision makes a substantive, nontechnical change in the law, and should be deleted. The REA made clear that the alternate payee is to be charged with receipt of the distributions made pursuant to a qualified order, regardless of whether the alternate payee is the participant's spouse. The proposed change makes a substantive change in this rule, and it will now be difficult to explain to participants why they are being taxed on income that they do not receive. Because the current law is easy to explain and to administer, it should not be changed. In any event, if the law is changed, conforming changes should be made in I.R.C. § 72(m)(10) (which requires the allocation of the participant's after-tax contributions among all alternate payees) and I.R.C. § 402(a)(1) (which requires plan distributions to be charged to the "distributee").

§ 2(c)(2)(i). To correct two clerical errors, line 5 on page 16 of the bill should be revised to read: "order determined to be qualified domestic".

§ 2(c)(2)(iv). To correct a clerical error, "beginning" should replace "beginnig" on line 9 of page 17. In addition, in order to make the amendment more accurate, "on" should be deleted and replaced with "as of" in line 9 on page 17; the same change should be made in line 19 on page 18.

§ 2(c)(4)(A)(v). Section 2(c)(4)(A)(v) amends I.R.C. § 414(p) to provide that the fact that a plan makes a payment to an alternate payee will not cause the plan to fail to meet the requirements of I.R.C. § 401(a) & (k) prohibiting payment of benefits before termination of employment. The amendment further provides that the foregoing protection against a court-ordered violation of § 401(a) or (k) will not apply if the present value of the payments to the alternate payee exceeds $3,500.

This provision should refer to I.R.C. § 409(d) as well as to § 401(a) & (k). See S. Rep. No. 575, 98th Cong., 2d Sess. 21 (1984).

The $3,500 limitation is wholly inappropriate and should be deleted. REA's qualified domestic relations order provisions clearly contemplate that a qualified order may require the payment of benefits before the participant has terminated employment. There is no justification for disqualifying a plan merely because it has observed the terms of a qualified domestic relations order.

The Joint Committee staff's description of H.R. 2110 indicates that this provision is intended to apply to a distribution that is made before the participant has either separated from service or attained the earliest retirement age under the plan. Section 2(c)(4)(A)(v) makes no reference to the plan's earliest retirement age and thus does not accomplish what the staff believes to have been intended. If the bill is revised to reflect this intention, corresponding changes should be made in the definition of a qualified order in I.R.C. § 414(p)(4) and ERISA § 206(d)(3)(E), which delineate the extent to which a qualified order may require payments not provided for under the plan. If these changes are not made, an order that requires a payment before the plan's earliest retirement age will not be a qualified order.

ERIC supports the Treasury Department's recommendation regarding § 2(c)(4)(A)(v): the provision should state that a plan may make payments to an alternate payee before the participant either separates from service or attains the plan's earliest retirement age if (i) a qualified order directs that the payments be made and (ii) the plan itself authorizes the payments.

§ 2(d). To correct a clerical error, "'qualifying rollover distribution'" should replace "'qualified rollover distribution'" in § 2(d)(1). A conforming change should be made in the heading of I.R.C. § 6652(j) by replacing "Certain Qualifying Rollover Distributions" with "Eligible Rollover Distributions."

§ 2(f)(1). Section 2(f)(1) amends REA § 303(c) to provide that in the case of a participant who is covered by a qualified preretirement survivor annuity pursuant to the transition rule set forth in REA § 303(c)(2), "the amount of any death benefit" payable to any beneficiary shall be reduced by "the amount payable to the surviving spouse" by reason of § 303(c)(2). In the interest of accuracy, the references in this provision to "the amount" of certain benefits should be changed to "the present value" of those benefits.

As drafted, the amendment requires a plan to offset the survivor annuity against the other death benefit. There is no apparent reason why a plan should be compelled to make this reduction. It should be sufficient to give each plan the option to make the reduction and to make it clear that a plan will not be disqualified under I.R.C. § 401(a) if it exercises this option.

In addition, the wording of the amendment suggests that a preretirement survivor annuity will be paid pursuant to REA § 303(c)(2). In fact, the annuity will be paid pursuant to plan provisions that comply with § 303(c)(2). The amendment should be revised to reflect this fact.

Finally, § 2(f)(1) should be expanded to include any participant described in REA § 303(c)(2)(A) & (B) who (i) is a participant in a plan that is amended, during the first plan year to which the REA amendments apply, to exempt it from the survivor annuity provisions, and (ii) dies on or after the date of enactment of REA and on or before the date the plan amendment is adopted.

Recommended Additions

ERIC recommends that the following provisions be added to H.R. 2110:

Anticutback Rule

(I.R.C. § 411(d)(6); ERISA § 204(g))

1. The bill should make clear that an alternative form of payment that is available only in the discretion of the plan administrator or a plan fiduciary is not an "optional form of benefit" for purposes of the anticutback rule. Likewise, the bill should make clear that the exercise of discretion under such a provision is not an amendment of the plan for purposes of the anticutback rule.

2. The bill should make clear that a plan amendment that eliminates the subsidy under a subsidized qualified preretirement survivor annuity does not reduce the participant's accrued benefit for purposes of the anticutback rule.

3. The bill should make clear that the anticutback rule does not prevent a plan from being amended to reduce benefits to reflect the cost of providing the qualified preretirement survivor annuity.

Maternity/Paternity Leave

(I.R.C. §§ 410(a)(5), 411(a)(6); ERISA §§ 202(b)(5), 203(b)(3))

1. The bill should make it clear that a plan that uses the elapsed time method (and which therefore already credits service for any absence of up to one year) is not required to credit additional service pursuant to REA's maternity/paternity leave provisions.

Qualified Survivor Annuities

(I.R.C. §§ 401(a)(11), 417; ERISA § 205)

1. The bill should amend the exception for profit-sharing and stock bonus plans to permit such plans to impose a one-year-of-marriage requirement without losing their eligibility for the exception. The bill should also make clear that I.R.C. § 401(a)(11)(B)(iii)(II) and ERISA § 205(b)(1)(C)(ii) do not require such plans to allow participants to elect life annuities.

2. The bill should clarify three aspects of the special rule regarding the qualified preretirement survivor annuity for a defined contribution plan in I.R.C. § 417(c)(2) and ERISA § 205(e)(2). First, the bill should make clear that the value of the participant's account balance may be adjusted for investment gains and losses occurring between the participant's date of death and the valuation date used to determine the amount of the annuity. Second, the bill should clarify when the survivor annuity must begin. Third, the bill should make clear that only the vested portion of the participant's account balance is taken into account under the special rule.

3. The bill should clarify the definition of "annuity starting date" in I.R.C. § 417(f)(2) and ERISA § 205(h)(2) by referring to "termination of employment" as well as to "retirement" and "disability."

4. The bill should make clear that a plan may presume that every participant is married, and may charge for the cost of preretirement survivor annuity protection, until and unless the participant waives the coverage in advance.

5. The bill should provide that when a participant files an effective waiver of qualified preretirement survivor annuity coverage, the plan may rely on the waiver until notified in writing that the participant has remarried.

6. The bill should make clear whether an election to waive the qualified joint and survivor annuity before the beginning of the applicable election period is valid. This is not made clear by I.R.C. § 417(a)(1)(A) and ERISA § 205(c)(1)(A).

7. The bill should make clear that since the qualified preretirement survivor annuity rules applied before the generally applicable effective date of REA, a plan may pass on the cost of the preretirement survivor annuity coverage during the pre-effective-date period automatically to all participants.

8. In many countries, the position of "notary public" does not exist. The bill should provide that in the case of a spousal consent executed outside of the United States, the consent may be witnessed by the equivalent of a notary public in the country where the consent is executed (as well as by a plan representative).

9. The bill should clarify that a plan may require a preretirement survivor annuity to begin as of the month next following the participant's death (or, if later, as of the month in which the participant would have attained the earliest retirement age under the plan).

10. The bill should correct a technical error in I.R.C. § 417(c)(1)(B) and ERISA § 205(e)(1)(B) by providing that if the participant dies after the earliest retirement date under the plan, the earliest period for which the surviving spouse may receive a payment under the qualified preretirement survivor annuity is the month following the month of the participant's death.

11. The bill should make clear that, in determining the size of the payments under a qualified joint and survivor annuity or a qualified preretirement survivor annuity, a plan may presume that the spouse's age is identical to that of the employee and may place the burden on the employee to prove otherwise.

12. The bill should amend REA § 303(e)(4)(A)(ii) to provide that a plan will not be deemed to fail to give notice before the Treasury fulfills its obligation to provide guidance on how to give notice under § 303(e)(4)(A)(i).

Qualified Domestic Relations Orders

(I.R.C. §§ 401(a)(13), 414(p); ERISA § 206(d))

1. The bill should make clear that a plan is bound by a qualified domestic relations order only if the plan has been made a party to the litigation and the court has jurisdiction over the plan.

2. The bill should amend I.R.C. § 414(p)(7)(C) and ERISA § 206(d)(3)(H)(iii) to make clear that a plan administrator may, in its discretion, refrain from paying the segregated amounts until the expiration of the 18-month period, even if it is determined that the order is not a qualified domestic relations order. This would confirm that the plan administrator has the authority to suspend payment, in its discretion, if it has reason to believe that the order may be amended within the 18-month period to cure any defect that originally prevented the order from qualifying.

Cash-Outs

(I.R.C. § 411(a)(11)(A); ERISA § 203(e)(1))

1. The bill should clarify that the bar against the immediate mandatory distribution of the present value of a benefit that exceeds $3,500 does not apply to a defined contribution plan.

2. The bill should clarify that the bar against the immediate mandatory distribution of the present value of a benefit that exceeds $3,500 applies only to lump sum distributions and not to annuity or installment distributions.

3. The bill should clarify that accumulated deductible employee contributions are disregarded when applying the $3,500 limit.

Notice of Forfeitability of Benefits

(I.R.C. § 6057; ERISA § 105)

1. The bill should clarify whether the required notice that benefits are forfeitable must be included in the statement of total accrued benefits and nonforfeitable accrued benefits furnished to plan participants who have not separated from service. Cf. H.R. Rep. No. 655, 98th Cong., 2d Sess. (Part 2) 3, 23 (1984); S. Rep. No. 575, *supra*, at 24-25.

LAW OFFICES
GROOM AND NORDBERG
CHARTERED
SUITE 700
1775 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20006

(202) 857-0620
DEX (202) 659-4503

THEODORE R. GROOM
CARL A. NORDBERG, JR.
ROBERT B. HARDING
LAWRENCE J. HASS
LOUIS T. MAZAWEY
MICHAEL F. KELLEHER
IRENE PRICE
GARY M. FORD
DANIEL HOROWITZ *
STEPHEN M. SAXON
ROBERT P. GALLAGHER
DOUGLAS W. ELL
WESLEY D. WORNOM
JOHN P. McALLISTER
TERRENCE M. DENEEN
CURTIS L. MUNCY †
MARY BALENT LONG

*ADMITTED IN VA. ONLY
†ADMITTED IN CA. ONLY

HOWARD J. SILVERSTONE
OF COUNSEL

June 12, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: June 5 Hearing on S. 814:
Participation of Full-Time Life
Insurance Salesmen in Cafeteria Plans

Dear Mr. Chairman:

This comment on S. 814, the Technical Corrections Act of 1985, relates to the ability of full-time life insurance salesmen ("FTLIS") to participate in cafeteria plans. FTLIS are independent contractors who are affiliated with a life insurance company and who primarily promote the life insurance and annuity products of that insurer. Under the Internal Revenue Code (the "Code"), FTLIS are treated as common law employees of the insurer for purposes of a number of statutory employee benefits, including many of the nontaxable benefits that may be offered as part of a cafeteria plan. Thus, the effect of FTLIS classification is to permit these independent contractors to participate in employee benefit programs that are otherwise limited to common law employees of the insurer. A life insurance company may have up to several thousand FTLIS.

We respectfully request that S. 814 include a provision to confirm that FTLIS may participate in a cafeteria plan if their selection of benefits is limited to taxable benefits and those nontaxable benefits for which they are deemed employees by statute. This change will prevent the anomalous result of a FTLIS who participates in a health program from being denied continued coverage under that same program merely because it is offered as part of a cafeteria plan.

Many large life insurance companies would like to implement a cafeteria plan in the near future to restrain escalating health costs. Because of considerations of equity, employee relations, and administrative costs, these companies want to treat FTLIS and common-law employees equally for employee benefit purposes. However, the Deficit Reduction Act of 1984 ("DEFRA") has generally been viewed as congressional ratification of the Treasury Department's proposed regulations governing cafeteria plans. Those regulations do not specifically refer to FTLIS, but cast doubt on the ability of FTLIS to participate in cafeteria plans to even the limited extent noted above. Moreover, at this point, it is highly unlikely that final regulations pertaining to cafeteria plans will be forthcoming in the near future.

This technical issue is thus of major concern to many large life insurance companies. We therefore believe it would be an appropriate technical correction to confirm that FTLIS may continue to be treated as employees for certain employee benefit purposes where those benefits are part of a cafeteria plan.

DISCUSSION

1. Background

A "full-time life insurance salesman" is defined by the regulations as an individual who, among other things, sells insurance or insurance products primarily for one insurance company.*/ Even though a FTLIS is not an "employee" of his or her affiliated insurance company under common law, section 7701(a)(20) of the Code provides that a FTLIS, as defined in the Social Security tax rules,**/ is deemed to be an employee for purposes of certain benefits provisions, and thus may participate in those benefit programs along with common law employees of the insurer.

---

*/ See Treas. Reg. § 31.3121(d)-1(d)(3)(ii).

**/ Another important consequence of FTLIS status is that a FTLIS is treated as an employee, rather than a self-employed individual, for purposes of the Social Security tax rules. See Code § 3121(d)(3)(B).

Among the benefits for which a FTLIS is treated as an employee by section 7701(a)(20) are (1) group-term life insurance, (2) accident and health plans, and (3) qualified pension, etc., plans, including cash or deferred arrangements. Thus, FTLIS are treated as employees for purposes of all of the nontaxable benefits that may be offered under a cafeteria plan except for group legal services (under section 120) and dependent care assistance (under section 129). The failure to specifically include FTLIS under sections 120 and 129 does not appear to reflect any congressional intent to restrict the participation of FTLIS in benefit programs. Rather, it appears that, in adding new forms of nontaxable benefits under sections 120 and 129, Congress simply overlooked the need to make corresponding amendments to section 7701(a)(20).[*/]

[*/] Section 7701(a)(20) was last amended in 1964 in connection with the enactment of the group term life insurance rules of section 79.

Section 125 of the Code does not itself define the term "employee" for purposes of the cafeteria plan rules, but Q&A 4 of the proposed regulations does. The definition provides, in pertinent part, that "[t]he term 'employees' does not, however, include self-employed individuals described in section 401(c) of the Code." Although FTLIS are self-employed individuals, they are also "statutory employees" under section 7701(a)(20) of the Code. However, the proposed regulations could be interpreted to imply that FTLIS may not be treated as employees for purposes of section 125 of the Code, and thus may not participate in a cafeteria plan.

DEFRA generally is considered to have ratified these proposed regulations governing cafeteria plans. It is important, therefore, that the technical corrections bill remove any implication that DEFRA ratified a definition of "employees" that precludes FTLIS from participating in a cafeteria plan. We understand that many large life insurance companies are concerned over this issue.

2. It Should Be Confirmed That FTLIS May Participate in a Cafeteria Plan If Their Selection of Benefits Is Limited to Cash and Those Benefits For Which They Are Already Considered Employees Under Current Law

We request confirmation that FTLIS may participate in a cafeteria plan if their selection of benefits is limited, by the terms of the plan, to taxable benefits and those nontaxable benefits for which they are already considered employees of their affiliated insurance company. For example, if a cafeteria plan maintained by an insurance company generally allows employees to choose among cash, group-term life insurance, medical insurance, group legal services, and dependent care, FTLIS should be permitted to participate if they may select any of those benefits except group legal services or dependent care.

In our view, such confirmation is consistent with section 125 and its legislative history. While the legislative history of section 125 states that plan participation is limited "to individuals who are employees,"[*/] the statute itself does not define the term "employee." Moreover, the adoption of our recommendation would in no way expand upon the benefits that an insurance company can provide to its FTLIS, or alter the tax treatment of those benefits when provided to a FTLIS. The confirmation would simply clarify that the constructive receipt principle of section 125 allows FTLIS to choose between taxable benefits and those nontaxable benefits that FTLIS are currently permitted to receive in the absence of a cafeteria plan.

[*/] S. Rep. No. 1263, 95th Cong., 2d Sess. 75 (1978).

We emphasize that the failure to confirm that FTLIS may participate in cafeteria plans to the limited extent suggested will impose needless additional benefit and administrative costs on insurance companies. For example, one major reason why life insurance companies (like many other employers) would consider implementing a cafeteria plan is to mitigate the impact on employees of health care cost saving measures (such as higher deductibles and copayments) that are being considered in connection with an insured health plan. If, however, a significant portion of its work force currently participating in its health plan (*i.e.*, several thousand FTLIS) are unable to participate in the cafeteria plan, an insurer may be reluctant to implement its health care cost containment objectives with respect to the ineligible group of FTLIS. In addition to perpetuating higher benefit costs, another significant effect of maintaining separate benefit programs for FTLIS and regular employees would be the administrative burdens and costs associated with the operation of multiple plans for different segments of its work force.

There is no apparent reason why FTLIS should be denied the opportunity to select among the benefits for which they are otherwise eligible according to their individual needs and circumstances. Indeed, the recommended confirmation would be consistent with a major objective of section 125

-- to facilitate the more effective delivery of employee benefits that are otherwise permitted under the Code and provided by an employer.

For all of the foregoing reasons, we respectfully request that S. 814 include a provision to confirm that FTLIS may participate in a cafeteria plan of an insurance company (with respect to which they have FTLIS status), but only if FTLIS are eligible to select solely among taxable benefits and the nontaxable benefits for which they are considered (under section 7701(a)(20)) employees of the insurance company.

Following is a draft of sample statutory language that could be used to confirm the treatment of FTLIS as we suggest:

____ Section 7701(a)(20) is amended by inserting the following language immediately after "employees' death benefits,":

> "for the purpose of applying the provisions of section 125 with respect to cafeteria plans (but only with respect to qualified benefits, as defined in section 125(f), which are either described in this paragraph or are subject to tax under subtitle A)"

You will note that the above language presupposes that section 153(b)(1) of S. 814 will be enacted and will amend Code section 125 such that cafeteria plans will be limited to the provision of "qualified benefits."

* * *

Thank you for your consideration of this issue. If you or your staff have any questions or comments, please feel free to call either of the undersigned persons.

Very truly yours,

Louis T. Mazawey

Douglas Ell

Douglas W. Ell

PENINSULA OFFICE
2275 EAST BAYSHORE ROAD
PALO ALTO, CALIFORNIA 94303
TELEPHONE (415) 856-4800

PORTLAND OFFICE
LLOYD CENTER TOWER
PORTLAND, OREGON 97232
TELEPHONE (503) 238-1700

HELLER, EHRMAN, WHITE & McAULIFFE
ATTORNEYS
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

44 MONTGOMERY STREET · SAN FRANCISCO, CALIFORNIA 94104
CABLE HELPOW · TELEX 340-895 · TELECOPIER (415) 772-6268
TELEPHONE (415) 772-6000

SEATTLE OFFICE
ONE UNION SQUARE
SEATTLE, WASHINGTON 98101
TELEPHONE (206) 447-0900

HONG KONG OFFICE
CARTON HOUSE, 17/F
1 DUDDELL STREET
HONG KONG
TELEPHONE 5-266616
TELEX 65665 LAWYR HX

June 11, 1985

VIA COURIER

Ms. Betty Scott-Boom
Committee on Finance
United States Senate
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Proposed Amendment to Effective Date of
Internal Revenue Code Section 312(n)(8)
Contained in Section 104(e)(3) of S. 814

Dear Ms. Scott-Boom:

This letter is submitted for the record of written comments on S. 814, the Technical Corrections Act of 1985.

Section 61(a) of the Tax Reform Act of 1984 (the "1984 Act") made several changes to the rules governing the computation of corporate earnings and profits as paragraphs (1) through (9) of Section 312(n) of the Internal Revenue Code. The effective date for Code Section 312(n)(8) was omitted from the 1984 Act. Section 104(e)(3) of S. 814 would cause the new statute (re-numbered as Section 312(n)(7)) to apply to distributions after July 18, 1984. Examination of the legislative history of this provision clearly indicates, however, that Section 312(n)(8) should be effective only for distributions in taxable years beginning after September 30, 1984, and I am writing to urge that the Technical Corrections Act be amended to state that effective date.

Code Section 312(n)(8) reverses the rule of Jarvis v. Commissioner, 43 B.T.A. 439 (1949), acq. Rev. Rul. 79-376, 1979-2 C.B. 133. Under Jarvis and Rev. Rul. 79-376, when a corporation redeemed a portion of its stock, the concomitant earnings and profits reduction was computed as the excess of the amount of the redemption over the portion of the corporation's historic (cost basis) capital account allocable to the redeemed shares. Under the new rule of Section 312(n)(8), the reduction in earnings and profits is proportional to the percentage of stock redeemed, generally resulting in a much smaller reduction of earnings and profits.

All of the 1984 Act's changes to the computation of corporate earnings and profits originated in Section 47 of the Senate bill, S. 2062. As proposed in Section 47(a)(1), the provisions in Code Section 312(n) were to be effective generally for "amounts paid or incurred in, or distributions or redemptions occurring in" taxable years beginning after the date of enactment. Specific exceptions to this general effective date covered new Code Sections 312(n)(4) (distributions of appreciated property), 312(n)(5) (LIFO adjustments), 312(n)(6) (installment sales), and 312(n)(7) (completed contract method of accounting). Under this formulation, the restrictive provisions of Code Section 312(n)(8) would not become effective until the taxpayer's first taxable year beginning after the date of enactment of the 1984 Act.

As finally adopted in Section 61 of the Conference report, the effective dates of the provisions contained in Code Section 312(n) were generally delayed until taxable years beginning after September 30, 1984. In form, the Conference report did not express Section 312(n)'s effective dates as a general rule with exceptions, as the Senate bill had, but instead expressed each effective date as a discrete provision matched with one or more paragraphs of Section 312(n). In the process of revising the structure of the effective date provisions, however, Section 312(n)(8) was overlooked. The Staff of the Joint Committee on Taxation, in the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (1984) ("General Explanation"), then took the position that Code Section 312(n)(8) is effective for distributions after July 18, 1984, the date of enactment of the 1984 Act (General Explanation, p. 181), and Section 104(e)(3) of the Technical Corrections Act now would confirm that effective date.

The effect of this change, however, is to unfairly burden taxpayers who reasonably relied upon the effective date contained in the Senate bill, since there was no reasonable notice of a different effective date in the Conference report. The Senate Finance Committee Report, S. Prt. No. 98-169, 98th Cong., 2d Sess. 202 (1984), in complete consonance with Section 47 of the Senate bill, stated that Code Section 312(n)(8) would be effective for "distributions in taxable years beginning after the date [of] enactment." The Conference Report, H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 840 (1984), states that "[t]he conference agreement is generally the same as the Senate amendment" regarding the provisions of Section 312(n)(8) and mentions no change in effective date, although other clarifications are discussed in detail.

In this context, I submit that it must be presumed that it was mere drafting error that caused the omission from the 1984 Act of a provision making Section 312(n)(8) of the Code effective for taxable years beginning after September 30, 1984. In a sense, this is an issue that goes to the basic faith kept between the Congressional tax committees and taxpayers generally. For taxpayers to be able to plan transactions with some modicum of certainty, they need to be assured that the effective date of a proposed new restriction, once announced, won't be made earlier, at least not without fair notice and a compelling reason to do so. In the case of the effective date of Code Section 312(n)(8), there was neither notice of an intended change, nor does any compelling reason suggest itself for distinguishing subsection (8) from the other subsections of Section 312(n) by cutting back on its effective date.

In consequence, I strongly urge that Section 104(e)(3) of S. 814 be amended to provide that present Code Section 312(n)(8) (to become Section 312(n)(7) after redesignation by S. 814) applies only to distributions occurring after September 30, 1984, in taxable years beginning after that date.

I appreciate your thoughtful consideration of this matter; please contact me if additional discussion of any of the points raised above would be helpful.

Very truly yours,

Glenn A. Smith

Glenn A. Smith

PENINSULA OFFICE
2575 EAST BAYSHORE ROAD
PALO ALTO, CALIFORNIA 94303
TELEPHONE (415) 858-4800

PORTLAND OFFICE
LLOYD CENTER TOWER
PORTLAND, OREGON 97232
TELEPHONE (503) 238-1700

HELLER, EHRMAN, WHITE & McAULIFFE
ATTORNEYS
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

44 MONTGOMERY STREET · SAN FRANCISCO, CALIFORNIA 94104
CABLE HELPOW · TELEX 340-895 · TELECOPIER (415) 772-6268
TELEPHONE (415) 772-6000

SEATTLE OFFICE
ONE UNION SQUARE
SEATTLE, WASHINGTON 98101
TELEPHONE (206) 447-0900

HONG KONG OFFICE
CAXTON HOUSE, 17F
1 DUDDELL STREET
HONG KONG
TELEPHONE 5-266618
TELEX 65688 LAWYR HX

June 11, 1985

Ms. Betty Scott-Boom
Committee on Finance
United States Senate
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Proposed Amendment to Section 555 of 1984 Tax Reform Act (Relating to Incentive Stock Options) Contained in Section 155 of S. 814

Dear Ms. Scott-Boom:

This letter is submitted for the record of written comments on S. 814, the Technical Corrections Act of 1985.

Section 555 of the Tax Reform Act of 1984 (the "1984 Act") changed the method of determining the fair market value of stock subject to an incentive stock option ("ISO") for purposes both of determining the exercise price of the ISO and of measuring the amount of the tax preference item (under Section 57(a)(10) of the Internal Revenue Code) when the ISO is exercised. The effective date provisions for these amendments are the subject of Section 155 of S. 814, the Technical Corrections Act of 1985, which would retroactively cause the tax preference provisions to apply to options which ISO holders could have reasonably believed to be "grandfathered" by the 1984 Act. I am writing to urge that this change not be made, or, if made, that it allow holders of these

ISOs some margin of time to exercise their options under the old rules.

Section 422A(c)(10) of the Code was added by the 1984 Act to provide that the fair market value of a share of ISO stock shall be determined without regard to any restrictions other than those that by their terms will never lapse ("non-lapse" restrictions). Section 57(a)(10) was amended by the 1984 Act to provide that for the purposes of the alternative minimum tax, the fair market value of a share of ISO stock on exercise of the underlying option is determined without regard to any restrictions other than non-lapse restrictions. In addition, Section 425(h)(3) of the Code was amended by the 1984 Act to provide that the modification of an option to make it non-transferable creates a new option.

The above three changes to the ISO rules are contained in, respectively, Sections 555(a)(1), 555(a)(2), and 555(b) of the 1984 Act, as follows:

> (a) DETERMINATION OF FAIR MARKET VALUE --
>
> (1) IN GENERAL -- Subsection (c) of section 422A (relating to special rules) is amended by adding at the end thereof of [sic] the following new paragraph:
>
> "(10) FAIR MARKET VALUE. -- For purposes of this section, the fair market value of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.".
>
> (2) INCENTIVE STOCK OPTION AS AN ITEM OF TAX PREFERENCE -- Paragraph (10) of section 57(a) (relating to items of

> tax preference) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, the fair market value of a share of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse."

The effective date provision covering subsection (2) above, and thus governing the new method of determining fair market value both under the ISO rules themselves and under the tax preference rules, is set forth in Section 555(c)(1) of the 1984 Act, which unequivocally makes the new two provisions of subsection (a) inapplicable to options granted on or before March 20, 1984:

> (c) EFFECTIVE DATES. --
>
> (1) FAIR MARKET VALUE. -- The amendment made by subsection (a) shall apply to options granted after March 20, 1984, except that such subsection shall not apply to any incentive stock option granted before September 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

As described below, Section 155 of the Technical Corrections Act would change this effective date as to the measurement of the ISO tax preference item to "grandfather" ISOs granted before March 20, 1984, only if they were exercised before January 1, 1985.

The reason that a change is now sought in this effective date provision is apparently contained in Section 555(c)(2) and (c)(3) of the 1984 Act, which provide as follows:

> (2) ITEMS OF TAX PREFERENCE. -- The amendment made by subsection (b) shall apply to options exercised after March 20, 1984. In the case of an option issued after March 20, 1984, pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984, the preceding sentence shall be applied by substituting "December 31, 1984" for "March 20, 1984."
>
> (3) MODIFICATIONS. -- The amendment made by subsection (c) shall apply with respect to modifications of options after March 20, 1984.

These two effective date provisions clearly present some difficulties of interpretation. By its terms, subparagraph (3) applies to the effective date provisions themselves, in subsection (c), even though the caption suggests that it was intended to apply to the modification provisions of subsection (b). Subparagraph (2) by its terms applies to the modification provisions of subsection (b) and also states a rule which is both convoluted and, when deciphered, unfair, in that it treats options granted after the new rules had been announced more favorably than those which were already in place.

Section 155 of the Technical Corrections Act would attempt to resolve these difficulties by (1) changing the effective date in Section 555(c)(1) of the 1984 Act to apply only to the ISO pricing provisions set forth in Section 555(a)(1) of the 1984 Act,

(2) changing the effective date provisions of Section 555(c)(2) of the 1984 Act to cover the tax preference rule contained in Section 555(a)(2) of the 1984 Act, and (3) changing the effective date provision in Section 555(a)(3) of the 1984 Act to apply to the modification rule in Section 555(b) of the 1984 Act. As to the tax preference provisions, the Joint Committee on Taxation's "Description of the Technical Corrections Act of 1985" (H.R. 1800 and S. 814) (JCS-7-85), Apr. 14, 1985, at p. 110, states that the change merely "clarifies" the 1984 Act.

For several reasons, the change that would be made in the effective date of the new tax preference rules is markedly unfair to taxpayers holding options granted on or before March 20, 1984.

First, as a matter of substantive law, taxpayers have been entitled to rely upon the clear and unambiguous language of Section 555(c)(1) of the 1984 Act, which "grandfathered" options granted on or before March 20, 1984 for both ISO and tax preference purposes. The Joint Committee Staff explanation that the proposed technical amendment merely "clarifies" the 1984 Act must be based principally upon the subheading of Section 555(c)(2) of the Act. However, the heading of Section 555(c)(1), "Fair Market Value" unambiguously refers to both the ISO rule change in Section 555(a)(1) and the tax preference change in Section 555(a)(2), both of which announce new rules for determining fair market value in those contexts, and it is an established rule of statutory construction in any event that although section and paragraph headings can be used to glean the intent of ambiguous provisions, they cannot be used to limit or negate plain meaning. Farr v. Commissioner, 33 B.T.A. 557, 564 (1935). Since Section 555(c)(1) is unambiguous on its face, under this rule any ambiguity arguably contained in Section 555(c)(2) would have no effect on it.

Second, the reasonableness of a taxpayer relying on this rule of construction is demonstrated by the fact that both of the major tax publishing houses, Prentice-Hall, Inc., and Commerce Clearing House, Inc., state in the booklets that each released as to the 1984 Act and in their current federal tax services, that the tax preference changes do not apply to options granted on or before March 20, 1984. Commerce Clearing House, Inc., Tax Reform Act of 1984, Law and Controlling Committee Reports, p. 123 (1984); Prentice-Hall, Inc., A Complete Guide to the Tax Reform Act of 1984, p. 705 (1984); Commerce Clearing House, Inc., Standard Federal Tax Reporter, Internal Revenue Code Vol. I, p. 4019-4 (1985); Prentice-Hall, Inc., P-H Federal Taxes 1985, Vol. 2, p. 6086 (1985). Copies of the foregoing pages, with the cited language marked, are attached hereto for ease of reference. It is thus clear that taxpayers' reliance upon the clear language of Section 555(c)(1) of the 1984 Act has been reasonable.

Third, before publication of the Joint Committee's General Explanation of the Deficit Reduction Act of 1985 on December 31, 1984, there was no clear expression of Congressional intent contrary to the plain language of Section 555(c)(1). Both the Senate Finance Committee Report, S.Prt. No. 98-169, 98th Cong., 2d Sess. 767 (1984) and the Conference Report, H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1178 (1984), state only that the ISO amendments are to be effective for "options granted, exercised, or modified (as the case may be) after March 20, 1984."

Next, as a common-sense matter, a taxpayer reading Section 555(c)(1) and 555(c)(2) together would probably conclude, particularly in light of the rule of statutory construction described above, that the principal drafting error was that Section 555(c)(2) was not dropped from the 1984 Act altogether. From the subsection references in Section 555(c), it seems a fair inference that at some point in the initial drafting process (most likely before the first appearance of these provisions in Section 827 of S. 2062), Section 555 was divided into four subsections, (a) through (d), subsection (a) stating the amendment that finally appeared in Section 555(a)(1) and subsection (b) containing the tax preference amendment. It is also a fair inference, however, that the intent of the draftsman was then to combine the two fair market value rules, which in terms of subject matter belong together, into a single subsection subject to a single effective date. This conclusion may also explain the garbled nature of Section 555(c)(2), on the ground that not much attention was paid to it since it was to be deleted in any event.

Finally, the amendment proposed by Section 155 of S. 814 appears inappropriate and unfair as it applies to the ISO tax preference provisions, in that it would again treat holders of options granted after the March 20, 1984 threshold date more favorably than taxpayers holding ISOs granted on or before that date. Taxpayers with qualifying post-March 20, 1984 ISOs at least had the benefit of knowing that there was a definite cut-off date -- December 31, 1984 -- by which they had to exercise or become subject to the new tax preference rules. Holders of pre-March 20, 1984 ISOs, however, had no definite warning of a cut-off date until the publication of the Joint Committee's General Explanation on December 31, 1984, followed by the introduction of H.R. 1800 and S. 814, which informed such taxpayers that (a) there is such a cut-off date and (b) that it has already passed.

For all of the reasons summarized above, I submit that fairness to taxpayers holding ISOs granted before March 20, 1984, dictates that they should receive a definite advance warning that they have only a limited period in which to exercise those options without becoming subject to the new ISO rules. At a minimum, I would propose that these taxpayers therefore be allowed some reasonable time -- *e.g.*, three to six months -- after enactment of the Technical Correction Act to make these exercises.

I appreciate your thoughtful consideration of this matter. Please contact me if additional discussion of any of the points raised above would be helpful.

Very truly yours,

Glenn A. Smith

HOUSTON NATURAL
GAS CORPORATION
P. O. Box 1188
Houston, Texas 77001
(713) 654-6955

ROBERT J. HERMANN
Vice President
Corporate Taxes

May 28, 1985

Mr. William M. Diefenderfer
Chief of Staff
Senate Finance Committee
United States Senate
219 Dirksen Office Building
Washington DC 20510

Dear Mr. Diefenderfer:

This is a written statement for the printed record in support of Section 175(c) of The Technical Corrections Act of 1985 (S. 814) concerning the treatment of sales within an affiliated group for purposes of Section 29 of the Internal Revenue Code of 1954 ("Code").

Section 29 of the Code (Section 44D before the Tax Reform Act of 1984) was enacted to encourage the production of natural gas from unconventional sources. It did so by providing a credit for production which in effect provided protection against significant decreases in the price of uncontrolled domestic oil, with which alternative fuels frequently compete. Thus, Congress provided an incentive in the nature of a credit to produce such natural gas. Furthermore, the credit provided producers with the choice between production incentive of the credit or an incentive price for such gas under Section 107 of the Natural Gas Policy Act.

In order to be sure the credit was only available for actual sales and to avoid transfers without substance among related parties ("churning") just to generate a credit, Congress inserted a "related party" rule. Unfortunately, the "related party" rule could be interpreted to prohibit the credit in cases where the gas is sold by a company's production subsidiary to its pipeline subsidiary which then resells the gas to an unrelated party. Not only would this deprive natural gas pipelines with production affiliates of the tax credit, but also create the anomalous possibility of a producer getting neither the incentive price nor the credit for unconventional gas. Both of these would be contrary to Congressional intent.

The technical revision included in Section 175(c) of the bill corrects this by allowing the credit so long as a corporation within an affiliated group sells the qualified fuels to an unrelated person. Since the credit is only available for the "first sale" and there must be an actual sale to an unrelated party, there is no violation of the purpose for the related party rule.

Therefore, on behalf of Houston Natural Gas Corporation, Houston, Texas, this letter is in support of the inclusion of the language of Section 175(c) in S. 814.

Sincerely,

Robert J Hermann

Robert J. Hermann

RJH/ceb

INDIANA MUNICIPAL POWER AGENCY

5920 CASTLEWAY WEST DRIVE, SUITE 118
P.O. BOX 50700
INDIANAPOLIS, INDIANA 46250
(317) 849-3242

FILE NO

May 28, 1985

Members of the Ways and Means
Committee of the United States
House of Representatives,
Members of the Finance Committee
of the United States Senate and
Members of the Indiana Congressional
Delegation
(Lists Attached)

Re: Comments on Certain Provisions of the Technical Corrections Act of 1985 - H.R. 1800 - S. 814

Ladies and Gentlemen:

We welcome this opportunity to comment on the provisions of the Technical Corrections Act of 1985 ("Act") that amend Section 103(o) of the Internal Revenue Code of 1954, as amended ("Code") and the staff explanation accompanying that provision. As provided for in Press Release #10 of April 22, 1985 and the Senate Finance Committee Release of May 8, 1985, we would ask that our comments be included in the record of the Ways and Means Committee and the Finance Committee, respectively. We request that the proposed amendment to Section 103(o) be rejected but that Section (o) be amended to make clear that its provisions do not adversely impact upon the issuance of tax exempt obligations to finance municipal ownership of electric power generation and transmission as now permitted by Section 103(a) of the Code.

When Congress adopted the Tax Reform Act of 1984, it was our understanding that Congress intended to limit the use of bond proceeds for the purpose of making loans to consumers and that Congress expressed this intent by enacting Section 103(o). Unfortunately, the precise language of that section can be read more broadly to include any arrangement between an issuer of bonds and a person that is not an exempt person within the meaning of Section 103(b)(3) of the Code ("non-exempt persons"), if that arrangement can be construed as an indirect loan of bond proceeds.

We point out that, despite our confidence that provisions of Section 103(o) were intended to reach only true consumer loans, the actual language of those provisions has been interpreted by many attorneys serving public power agencies to apply to many power transactions because of the literal language of the statute. Obviously, this situation has a chilling effect on the ability of public power suppliers to consummate transactions, especially because the concept of an indirect loan is not adequately set forth in the statute and has not been elucidated in Treasury Regulations ("Regulations"). We also point out that the Department of the Treasury ("Treasury") and staff must have recognized that many observers feel that it was Congressional intent to affect only true consumer loans. Otherwise there would have been no need for Congress to change the language in Section 103(o) to restrict "private loan bonds" nor would there have been a necessity for staff commentary accompanying the Act that indicates a clear intent to reach transactions beyond true consumer loans.

Due to the lack of clarity in the law and questions about Congressional intent, many issuers of municipal bonds requested the Treasury to implement Regulations explaining that section so that municipal issuers could have some assurance that arrangements with non-exempt persons who were not consumers were not covered by the Act and have some idea what the Treasury would consider an indirect loan. Proposed regulations have not been forthcoming. Instead, the Act makes clear that all private loans, including all loans to non-exempt persons other than consumers, involving more than a significant portion of the proceeds of a particular bond issue will not bear interest that is tax exempt under Section 103(a) of the Code. Earlier staff commentary on Section 103(o) indicates that any amount in excess of 5% constitutes a significant portion. In addition, the proposed amendment to Section 103(o) does not clarify the question of what constitutes an indirect loan and, therefore, leaves issuers of tax exempt bonds in a position of uncertainty and waiting for the promulgation of Regulations to explicate those provisions, assuming any such Regulations will ever be forthcoming.

Our view is that Congress should indeed amend Section 103(o) to clarify their intent that its provisions apply only to bond proceeds that are actually loaned to consumers rather than to other non-exempt persons. We are persuaded that this was Congressional intent in first enacting the statute and that this intent should not be undermined in the guise of "technical corrections" to the Code.

The Indiana Municipal Power Agency ("IMPA") is a political subdivision of the State of Indiana that provides power and energy to its 25 municipal members. These members are municipalities with a population of 250,000 and utilities that currently provide services to approximately 130,000 retail customers. These municipalities have been providing services to customers for decades and, in some instances, since the 19th century. These municipalities and agencies like IMPA have been able to serve the public purpose of providing electricity to consumers by financing facilities for the generation and transmission of electricity through the issuance of tax exempt bonds. The Indiana Supreme Court has long recognized the public purpose served by this provision of electrical service.

IMPA was formed to allow the member municipalities to collectively negotiate for the purchase of power with other utilities and to collectively purchase generation and transmission facilities to provide those members with the economies of scale in the electric utility industry that have long been enjoyed by investor-owned utilities as opposed to each small municipal utility operating its own, relatively inefficient system.

Under the current provisions of the Code and the Regulations promulgated under Section 103(b), IMPA may issue its bonds for generation or transmission and distribution facilities and enter into arrangements with non-exempt persons as a co-owner of those facilities. The contractual arrangements between IMPA and a non-exempt person typically allow IMPA to provide for expected growth in generation needs of its members by investing more now to achieve the necessary power supply facilities in the future. For example, if IMPA feels that it will need a certain amount of power in 1995, it might purchase facilities that would provide more than enough power for its members in 1986 but would provide, on an estimated basis, adequate power in 1995. This type of planning is traditional and necessary in the electric utility industry because of the long lead time required to build facilities to serve future needs. The current provisions of the Code and those Regulations recognize the advisability of allowing IMPA to sell back power from the facility until IMPA and its members need that power, assuming the other requirements of the Regulations are met, to non-exempt persons. See Regulation 1.103-7(b)(5) (attached). As long as IMPA does not sell more than 25% of the power from the facility over an average term set forth in those Regulations, the bonds are not industrial development bonds and are, therefore, eligible for the tax exemption provided under the current provisions of Section 103(a) of the Code. However, if such a sell back arrangement is construed to be a direct or indirect loan of 5% or more of the bond proceeds, the tax exemption would be lost under Section 103(o).

Another potential example of a situation where IMPA's inability to serve the public purpose for which it was created because of the denial of the tax exemption provided by Section 103(a) if the new Section 103(o) is adopted, or if the existing provisions are interpreted to include non-consumer loans, occurs when IMPA desires to purchase transmission or distribution facilities in co-ownership with a non-exempt person. Even where IMPA structures its contract for ownership of those facilities so that IMPA's ownership interest is designed to match its use of the entire transmission system precisely, there are necessarily some payments for services rendered for transmission facilities between the co-owners as transmission fluctuates. Of course, given variations in electric power loads due to weather conditions, among other things, the use of transmission facilities that are co-owned by more than one utility always fluctuates. There is a possibility that IMPA's facilities might be used over a period of time because of those fluctuations by an investor-owned utility, a non-exempt person, and that the Internal Revenue Service would argue that the payment arrangements for such use constitute an "indirect loan" of the bond proceeds used to finance IMPA's facilities if, for that period of time, the non-exempt person's use of IMPA's facilities consisted of 5% or more of those facilities. Obviously, IMPA currently has little guidance on whether these contractual arrangements would be viewed as an indirect loan by the Internal Revenue Service.

The bottom line is that public power accounts for a significant amount of electrical power generated and delivered to consumers throughout the United States and that local governments have traditionally supplied these services to benefit their citizens and residents. The main financing tool used by these providers is municipal bond issues that bear interest that is tax exempt under Section 103(a) of the Code. To maintain the exemption for the types of bonds issued to provide generation and transmission facilities, we would urge that Section 103(o) not be amended in the form proposed and that the definition of consumer loan bond be amended to read:

> The term "consumer loan bond" means any obligation which is issued as part of an issue all or a significant portion of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans (other than loans described in subparagraph (c)) to persons who are consumers (within the meaning of paragraph (D)).

As a corollary, we would suggest that "consumers" be defined in a new paragraph (D) under Section 103(o) and that such definition accurately reflect the intent of Congress to only affect consumers. For your information, we enclose herewith a definition from the Uniform Commercial Credit Code.

An alternative approach that would protect public power issuers would be to insert a subparagraph (iii) in Section 103(o)(C) that reads:

> (iii) consists of a financial arrangement

> between an exempt person and persons who are not exempt persons (within the meaning of subsection (b)(3)) pursuant to which the exempt person or persons and the person or persons who are not exempt have ownership interests in facilities for the provision of utility services or pursuant to which any payments made by the person or persons who are not exempt have been approved by, or are effective through filing with, any federal or state body with the authority to regulate rates or tariffs.

Of course, if this change were incorporated, the word "or" after subparagraph (i) would have to be deleted and a ", or" would have to replace the period after subparagraph (ii).

A third potential solution would be to clarify the phrase "directly or indirectly to make or finance loans" within Section 103(o). Congress could provide a safe harbor so that public power agencies would at least be able to structure their financings with some degree of certainty. Again, while it could be said that Regulations could be adopted to clarify these provisions, such Regulations have not been forthcoming within a period of almost a year. We would suggest that the concept in the staff explanation of Section 103(o) that was presented after the adoption of the Tax Reform Act of 1984 could be included within this definition of a loan or indirect loan. In essence, those comments indicated that the language of Section 103(o) should be construed to incorporate transactions that were loans in substance if not in form. There are various tests that the Internal Revenue Service has developed to focus on that issue and incorporation of one of those tests could provide such a safe harbor.

If the third alternative is selected, we would suggest that any safe harbor provisions contain specific language, similar to that suggested above for a new (C)(iii), applicable to municipal utilities and public power agencies, that recognize the proposition that no arrangement between a utility that issues municipal bonds and a customer of that utility shall be considered a consumer loan or private loan if payments by the non-exempt persons are pursuant to rates or tariffs filed with or approved by state or federal bodies charged with regulating those rates or tariffs by law.

The suggestions for changes to Section 103(o) outlined above would also protect municipal utilities, including IMPA members, across the country from the threat of having their bond issues rendered taxable because of the consumer loan bond provisions. Municipal utility issuers often have substantial commercial or industrial usage of the services they provide from facilities that were financed with tax exempt bonds. The current Regulations promulgated under Section 103(b) of the

Code allow those issuers to provide those services to residential, commercial and industrial users without becoming industrial development bonds and, therefore, in most circumstances, taxable, so long as the facilities financed by the issuance of bonds are available for general public use. Under certain circumstances, the current Section 103(o), or the proposed amendments, can inhibit an issuer from providing new facilities because of the concern that its sale of services to a non-exempt person will be construed as an indirect loan.

These concerns apply not only to municipal electric utilities, but to municipal sewage, water and gas utilities as well. There are hundreds of such utilities in the State of Indiana that have traditionally served municipal customers. These utilities range in size from utilities serving less than 100 customers to utilities serving hundreds of thousands of customers.

We would be happy to answer any questions you might have about these comments or the provisions of Section 103(o) as they apply to public power agencies and municipal electric utilities. Please do not hesitate to call me at 317/849-3242, if you have any such questions or comments. Any technical legal questions should be addressed to our bond counsel, Thomas K. Downs of Ice Miller Donadio & Ryan, at 317/236-2339, or our general counsel, James R. McClarnon of Smith Morgan & Ryan, at 317/636-5401. Kindest regards.

Sincerely,

Jesse C. Tilton III
General Manager,
Indiana Municipal Power Agency

JCT/scd

Attachments

Caution: Reg. § 1.103-7 does not reflect amendments made to Code Sec. 103 by P. L. 94-455 (Tax Reform Act of 1976), P. L. 97-248 (TEFRA), and P. L. 98-369 (Tax Reform Act of 1984). See ¶ 947.01 et seq.

[¶ 981]—Continued

being used in the trade or business of a nonexempt person in situations involving other arrangements, whether in a single transaction or in a series of transactions, whereby a nonexempt person uses property acquired with the proceeds of a bond issue in its trade or business.

(iii) The use of more than 25 percent of the proceeds of an issue of obligations in the trades or businesses of nonexempt persons will constitute the use of a major portion of such proceeds in such manner. In the case of the direct or indirect use of the proceeds of an issue of obligations or the direct or indirect use of a facility constructed, reconstructed, or acquired with such proceeds, the use by all nonexempt persons in their trades or businesses must be aggregated to determine whether the trade or business test is satisfied. If more than 25 percent of the proceeds of a bond issue is used in the trades or businesses of nonexempt persons, the trade or business test is satisfied. For special rules with respect to the acquisition of the output of facilities, see subparagraph (5) of this paragraph.

(4) *Security interest test.* The security interest test relates to the nature of the security for, and the source of, the payment of either the principal or interest on a bond issue. The nature of the security for, and the source of, the payment may be determined from the terms of the bond indenture or on the basis of an underlying arrangement. An underlying arrangement to provide security for, or the source of, the payment of the principal or interest on an obligation may result from separate agreements between the parties or may be determined on the basis of all the facts and circumstances surrounding the issuance of the bonds. The property which is the security for, or the source of, the payment of either the principal or interest on a debt obligation need not be property acquired with bond proceeds. The security interest test is satisfied if, for example, a debt obligation is secured by unimproved land or investment securities used, directly or indirectly, in any trade or business carried on by any private business user. A pledge of the full faith and credit of a State or local governmental unit will not prevent a debt obligation from otherwise satisfying the security interest test. For example, if the payment of either the principal or interest on a bond issue is secured by both a pledge of the full faith and credit of a State or local governmental unit and any interest in property used or to be used in a trade or business, the bond issue satisfies the security interest test. For rules with respect to the acquisition of the output of facilities, see subparagraph (5) of this paragraph.

(5) *Trade or business test and security interest test with respect to certain output contracts.* (i) The use by one or more nonexempt persons of a major portion of the subparagraph (5) output of facilities such as electric energy, gas, or water facilities constructed, reconstructed, or acquired with the proceeds of an issue satisfies the trade or business test and the security interest test if such use has the effect of transferring to nonexempt persons the benefits of ownership of such facilities, and the burdens of paying the debt service on governmental obligations used directly or indirectly to finance such facilities, so as to constitute the indirect use by them of a major portion of such proceeds. Such benefits and burdens are transferred and a major portion of the proceeds of an issue is used indirectly by the users of the sub-

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paragraph (5) output of such a facility which is owned and operated by an exempt person where—

(*a*)(*1*) One nonexempt person agrees pursuant to a contract to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output (within the meaning of subdivision (ii) of this subparagraph) of such a facility (whether or not conditional upon the production of such output) or (*2*) two or more nonexempt persons, each of which pays annually a guaranteed minimum payment exceeding 3 percent of the average annual debt service with respect to the obligations in question, agree, pursuant to contracts, to take, or to take or pay for, a major portion (more than 25 percent) of the subparagraph (5) output of such a facility (whether or not conditioned upon the production of such output), and

(*b*) Payment made or to be made with respect to such contract or contracts by such nonexempt person or persons exceeds a major part (more than 25 percent) of the total debt service with respect to such issue of obligations.

(ii) For purposes of this subparagraph—

(*a*) Where a contract described in subdivision (i) of this subparagraph may be extended by the issuer of obligations described therein, the term of the contract shall be considered to include the period for which such contract may be so extended.

(*b*) The subparagraph (5) output of a facility shall be determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the contract term of the issue of obligations issued to provide such facility. The number of units produced or to be produced by a facility in one year shall be determined by reference to its nameplate capacity (or where there is no nameplate capacity, its maximum capacity) without any reduction for reserves or other unutilized capacity. The contract term of an issue begins on the date the output of a facility is first taken, pursuant to a take or a take or pay contract, by a nonexempt person and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption dates). If, however, on or before the date of issue of a prior issue of governmental obligations issued to provide a facility, the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, then the contract term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue with respect to such facility (determined without regard to any optional redemption dates). Where it appears that the term of an issue (or the terms of 2 or more issues) is extended for purposes of extending the contract term of an issue and thereby increasing the subparagraph (5) output of the facility provided by such issue, the subparagraph (5) output of such facility shall be determined by the Commissioner without regard to the provisions of this subdivision (*b*).

(*c*) The total debt service with respect to an issue of obligations shall be the total dollar amount (excluding any penalties) payable with respect to such issue over its entire term. The entire term of an issue begins on its date of issue and ends on the latest maturity date of any obligation of the issue (determined without regard to any optional redemption

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[¶ 981]—Continued

dates). If, however, on or before the date of issue of a prior issue of governmental obligations the issuer makes a commitment in the bond indenture or related document to refinance such prior issue with one or more subsequent issues of governmental obligations, the entire term of the issue shall be determined with regard to the latest redemption date of any obligation of the last such refinancing issue (determined without regard to any optional redemption dates).

(*d*) Two or more nonexempt persons who are related persons (within the meaning of section 103(c)(6)(C)) shall be treated as one nonexempt person.

(c) *Examples.* The application of the rules contained in section 103(c)(2) and (3) and paragraph (b) of this section are illustrated by the following examples:

Example (1). State A and corporation X enter into an arrangement under which A is to provide a factory which X will lease for 20 years. The arrangement provides (1) that A will issue $10 million of bonds, (2) that the proceeds of the bond issue will be used to purchase land and to construct and equip a factory in accordance with X's specifications, (3) that X will rent the facility (land, factory, and equipment) for 20 years at an annual rental equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that such payments by X and the facility itself will be the security for the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used (by purchasing land and constructing and equipping the factory) in a trade or business by a nonexempt person, and (2) the payment of the principal and interest on which is secured by the facility and payments to be made with respect thereto.

Example (2). The facts are the same as in example (1) except that (1) X will purchase the facility, and (2) annual payments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds will be made by X. The bonds are industrial development bonds for the reasons set forth in example (1).

Example (3). State B and corporation X enter into an arrangement under which B is to loan $10 million to X. The arrangement provides (1) that B will issue $10 million of bonds, (2) that the proceeds of the bond issue will be loaned to X to provide additional working capital and to finance the acquisition of certain new machinery, (3) that X will repay the loan in annual installments equal to the amount necessary to amortize the principal and pay the interest on the outstanding bonds, and (4) that the payments on the loan and the machinery will be the security for only the payment of the principal on the bonds. The bonds are industrial development bonds since they are part of an issue of obligations (1) all of the proceeds of which are to be used in a trade or business by a nonexempt person, and (2) the payment of the principal on which is secured by payments to be made in respect of property to be used in a trade or business. The result would be the same if only the payment of the interest on the bonds were secured by payments on the loan and machinery.

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sale, such as delivery, installation, alterations, modifications, and improvements, and (b) taxes to the extent imposed on a cash sale of the goods, services, or interest in land. The cash price stated by the seller to the buyer in a disclosure statement required by law is presumed to be the cash price.

(10) "Conspicuous":

A term or clause is "conspicuous" when it is so written that a reasonable person against whom it is to operate ought to have noticed it. Whether or not a term or clause is conspicuous is for decision by the court.

(11) "Consumer" means the buyer, lessee, or debtor to whom credit is granted in a consumer credit transaction.

(12) "Consumer credit sale":

(a) Except as provided in paragraph (b), "consumer credit sale" means a sale of goods, services, or an interest in land in which:

(i) credit is granted either pursuant to a seller credit card or by a seller who regularly engages as a seller in credit transactions of the same kind;

(ii) the buyer is a person other than an organization;

(iii) the goods, services, or interest in land are purchased primarily for a personal, family, household, or agricultural purpose;

(iv) the debt is payable in instalments or a finance charge is made; and

(v) with respect to a sale of goods or services, the amount financed does not exceed $25,000.

(b) A "consumer credit sale" does not include:

(i) a sale in which the seller allows the buyer to purchase goods or services pursuant to a lender credit card, or

(ii) unless the sale is made subject to this Act by agreement (Section 1.109), a sale of an interest in land if the finance charge does not exceed 12 per cent per year calculated according to the actuarial method on the assumption that the debt will be paid according to the agreed terms and will not be paid before the end of the agreed term.

(c) The amount of $25,000 in paragraph (a)(v) is subject to change pursuant to the provisions on adjustment of dollar amounts (Section 1.106).

(13) "Consumer credit transaction" means a consumer credit sale or consumer loan or a refinancing or consolidation thereof, or a consumer lease.

(14) "Consumer lease":

(a) "Consumer lease" means a lease of goods:

(i) which a lessor regularly engaged in the business of leasing makes to a person, except an organization, who takes under the lease primarily for a personal, family, household, or agricultural purpose;

(ii) in which the amount payable under the lease does not exceed $25,000;

(iii) which is for a term exceeding four months; and

(iv) which is not made pursuant to a lender credit card.

(b) The amount of $25,000 in paragraph (a)(ii) is subject to change pursuant to the provisions on adjustment of dollar amounts (Section 1.106).

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INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

1101 SIXTEENTH ST., N.W.
WASHINGTON, D. C. 20036
(202) 857-4722

HAROLD "BUD" SCOGGINS
GENERAL COUNSEL
VICE PRESIDENT-GOVERNMENT RELATIONS
(202) 857-4731

June 12, 1985

Ms. Betty Scott-Boom
Committee on Finance
Room SD - 219
U.S. Senate
Washington, D.C. 20510

Subject: Technical Corrections Act of 1985 (H.R. 1800; S. 814)

Dear Ms. Boom:

Attached, for the written record of public hearing in connection with the Technical Corrections Act of 1985 ("the Act"), is a written statement of the Independent Petroleum Association of America (IPAA) setting forth an additional technical correction item our organization developed through our tax committee. The technical correction item is a supplement to our prior submission dated May 23, 1985. We appreciate the opportunity to offer this technical correction item to the tax writing committee in connection with legislative consideration of the Act.

The specific technical correction item we are submitting is as follows:

1. Proposed correction to Sec. 465(c) to treat a partner's or shareholder's interest in a partnership or S corporation, respectively, as a single activity with respect to all oil or gas or geothermal properties held by the entity.

Questions regarding our written statement should be directed to David Blair (857-4734) of our office or the undersigned.

Sincerely,

H B Scoggins Jr

H.B Scoggins, Jr.

Enclosure (1)

STATEMENT OF

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

AND

AMERICAN ASSOCIATION OF PETROLEUM LANDMEN
ARKOMA BASIN INDEPENDENT GAS PRODUCERS ASSOCIATION
CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION
EASTERN KANSAS OIL AND GAS ASSOCIATION, INC.
ILLINOIS OIL AND GAS ASSOCIATION
INDEPENDENT OIL AND GAS ASSOCIATION OF WEST VIRGINIA
INDEPENDENT OIL PRODUCERS TRI-STATE, INC.
INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES
INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO
INDIANA OIL AND GAS ASSOCIATION
KENTUCKY OIL AND GAS ASSOCIATION
LIAISON COMMITTEE OF COOPERATING OIL AND GAS ASSOCIATIONS
LOUISIANA LANDOWNERS ASSOCIATION, INC.
LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS AND ROYALTY OWNERS
MICHIGAN OIL AND GAS ASSOCIATION
NATIONAL STRIPPER WELL ASSOCIATION
NEW YORK STATE OIL PRODUCERS ASSOCIATION
NORTH TEXAS OIL AND GAS ASSOCIATION
OHIO OIL AND GAS ASSOCIATION
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
PANHANDLE PRODUCERS AND ROYALTY OWNERS ASSOCIATION
PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION
PENNSYLVANIA OIL AND GAS ASSOCIATION
PERMIAN BASIN PETROLEUM ASSOCIATION
ROYALTY OWNERS AND INDEPENDENT OIL AND GAS PRODUCERS ASSOCIATION OF ARKANSAS
TENNESSEE OIL AND GAS ASSOCIATION
TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION
VIRGINIA OIL AND GAS ASSOCIATION
WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION

Technical Corrections Act
of 1985
(H.R. 1800; S. 814)

ITEM 4
AGGREGATION OF OIL AND GAS OR GEOTHERMAL PROPERTIES IN PARTNERSHIP OR S CORPORATION IN APPLYING "AT-RISK" RULES

BACKGROUND AND DESCRIPTION OF ITEM

Prior to the Tax Reform Act of 1984 ("the Act"), a partner's interest in a partnership or a shareholder's interest in an S corporation was treated as a single activity for purposes of applying the "at-risk" rules of Sec. 465 with respect to the ownership of oil and gas or geothermal properties (as defined under Sec. 614). The Act eliminated the partnership and S corporation aggregation rule of old Sec. 465(c)(2), thus requiring property-by-property "at-risk" determinations.

The amendment to Sec. 465(c)(2) made by the Act in many cases creates an administrative nightmare for the entity and its owners by requiring the filing of Form 6198 by each partner (or shareholder) for each property in the partnership (or S corporation) having a "loss". It is not uncommon for an oil and gas limited partnership with, for example, 30 partners, to own interests in, say, 50 producing and non-producing properties. If each property had a "loss", the limited partnership might, if "tainted" indebtedness exists, have to furnish information to its 30 partners such that property-by-property "at-risk" computations might be made by the partners. The IRS could receive up to 1500 (30 partners x 50 properties) Form 6198s from the partnership's 30 partners when they filed their tax returns.

Although oil and gas activity is seldom financed with nonrecourse debt, temporary operating "advances" from, for example, a general partner to a limited partnership, constitute prohibited borrowings under Sec. 465(b)(3)(A), such that "losses" with respect to properties in the partnership frequently exist. The administrative problems of the property-by-property "at-risk" rule are exacerbated by the fact that:

1. Treasury has not prescribed methodology by which to make property-by-property allocations for purposes of "at-risk" calculations, and
2. The necessity to establish January 1, 1984 "at-risk" basis for each property where economic activity existed prior to December 31, 1983.

As a practical matter, the aggregation rules of Sec. 465(c)(2)(B)(ii) are of limited applicability.

Because of the administrative complexities noted above, IRS suspended application of the statutory amendment to Sec. 465(c)(2) made by the Act for the 1984 filing season (Temp. Reg. 1.465-1T (3-11-85)). The Joint Committee on Taxation estimates that the Act's amendments to Sec. 465 have a negligible revenue effect. We believe there is little, if any, opportunity for taxpayer manipulation of the "at-risk" rules if aggregate "at-risk" computations for partnership and S corporations are permitted.

RECOMMENDED TECHNICAL CORRECTION

We recommend the following statutory change to Sec. 465:

1. Redesignate Sec. 465(c)(2)(B)(ii) as (iii).
2. Add new Sec. 465(c)(2)(B)(ii), as follows:

> "SPECIAL RULE FOR EXPLORING FOR, OR EXPLOITING, OIL AND GAS OR GEOTHERMAL PROPERTIES. - In the case of a partner's interest in a partnership or a shareholder's interest in an S corporation, all activity with respect to the exploration for oil and gas resources or geothermal deposits (as defined in Sec. 613(e)(3)) shall be treated as a single activity."

We recommend that Sec. 465(c)(2)(B)(ii), as amended above, be modified to include a taxpayer's activity with respect to film or video tapes or farming (Sec. 465(c)(2)(A)(i) and (iii)) as appropriate. Our recommended technical correction, if adopted, should be effective for taxable years beginning on or after January 1, 1985.

Statement of the
Investment Company Institute on
The Technical Corrections Act of 1985 (S. 814)
and the Retirement Equity Act of 1984
Technical Corrections Act (H.R. 2110)
before the
Senate Finance Committee
June 5, 1985

The Investment Company Institute* (the "Institute") offers the following comments and proposals regarding those provisions of S. 814 and H.R. 2110 which affect mutual funds and their shareholders.

1. Holding Period for Losses Incurred with Respect to Tax-Exempt Mutual Funds

Section 104(c) of S. 814, as introduced, would amend Code section 852(b)(4)(B) to deny a shareholder's loss on the sale or exchange of stock in a regulated investment company ("RIC"), more commonly known as a mutual fund, to the extent that the shareholder has received exempt-interest dividends* on that stock if the shareholder has held the stock for less than six months. Under current law, such losses are disallowed only if the shareholder has held the stock for less than 31 days. The proposed extension of the holding period for RIC stock would make this holding period requirement consistent with the 6 months holding period requirement adopted in the Tax Reform Act of 1984 with respect to losses incurred following the payment of a long-term capital gain dividend.

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*The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 1,140 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about $345 billion, accounting for approximately 90% of total industry assets, and have approximately 20 million shareholders.

**Code section 852(b)(5) permits a qualifying mutual fund to pay an exempt-interest dividend to its shareholders if, at the close of each quarter of its taxable year, at least 50 percent of the total assets of the fund are invested in obligations exempt from tax under Code section 103(a). In fact, these funds have substantially all of their assets invested in tax-exempt obligations. Exempt-interest dividends are treated by the shareholders as interest excludable from income under section 103(a).

Presumably this proposal is based upon a belief that the current 31-day holding period is an insufficient deterrent to tax-motivated transactions by shareholders seeking to generate both tax-exempt income in the form of an exempt-interest dividend and short-term capital losses from the sale of the RIC stock when the stock declines in value upon going ex-dividend.

The Institute believes that the proposed extension of the holding period should not apply to those RICs whose share price never reflects any significant amount of tax-exempt interest previously earned by the fund prior to the taxpayer's purchase of the shares as, for example, in the case of a fund which declares dividends daily. The following example illustrates a fund which does not permit the abusive transaction sought to be prevented: Assume a RIC which declares exempt-interest dividends daily in an amount that substantially equals the exempt-interest earned by the RIC each day. Dividends are paid at the end of each month, but, because the dividends are declared daily, a shareholder is entitled to receive dividends only for those days during the month on which he held stock in the RIC.

Thus, if the RIC stock is valued at $10.00 per share and the RIC pays dividends at the rate of 1% per month, a shareholder who held the stock for the entire month of June would receive a dividend of 10 cents on June 30. A taxpayer who acquired the stock on June 24 would receive only 2 cents per share on June 30. Moreover, the value of the stock on June 24 would not include any amount representing a right to receive income previously earned by the RIC, since purchasers of the stock on June 24 did not acquire any right to receive such amounts. Rather, interest earned by the RIC before June 24 would have already been declared on prior days as dividends receivable by those who were shareholders on those prior days and would have already reduced the price of the stock.

If the shareholder who acquired his stock on June 24 were to sell his stock on July 1, no change in the value of the RIC stock could be attributable to the payment of dividends by the RIC that included interest earned by the RIC prior to June 24. Thus, the tax-motivated transaction that the proposed 6-month rule seeks to discourage cannot occur in this case.

We believe that our proposed amendment to the holding period rule in section 104(c) of the bill would achieve the intended purpose of discouraging tax-motivated transactions in RIC shares without imposing an undue penalty on shareholders whose transactions in RIC stock are not tax-motivated. Such a penalty would be imposed, under the amendment contained in S. 814, if the value of RIC shares declined as the result of an increase in interest rates and the shareholder could not deduct the loss because he had received exempt-interest dividends, even though the dividends had nothing to do with the decline in value of the RIC shares. The penalty results, in effect, from a presumption that any loss on a disposition of RIC shares is due to the receipt of exempt-interest dividends (up to an amount equal to the amount of such dividends) rather than some other cause, such as an increase in interest rates.

In lieu of section 104(c) of S. 814, the Institute recommends the application of a six month holding period requirement except to the extent the Secretary provides in regulations for reduced holding period requirements for stock in RICs that regularly declare exempt-interest dividends in an amount that is not less than 90% nor more than 110% of the net tax-exempt income, i.e., tax-exempt interest net of expenses, it has earned during the period between each dividend declaration date. If a RIC satisfies these requirements, the required holding period is reduced to the number of days in the dividend declaration cycle. For example, if a RIC satisfies these requirements and declares dividends daily, the required holding period would be one day. With respect to RICs that satisfy these requirements and declare exempt-interest dividends monthly or quarterly, the required holding periods would be one month or three months, respectively.*

Attached as Appendix A are proposed statutory language and proposed language for the Committee Report relating to section 104(c) of S. 814.

2) Personal Holding Company Recordkeeping Requirements Applicable to RICs

Section 1071 of the Tax Reform Act of 1984 eliminated from the RIC qualification provisions the prohibition that a RIC could not be a personal holding company. Thus a RIC will not fail to qualify under Subchapter M solely by virtue of its status as a personal holding company, as defined in Code section 542. However, as amended by section 1071 of the Tax Reform Act, Code section 852(b) provides that a RIC which is a personal company

*With respect to RICs that declare dividends monthly or quarterly, it is possible for a taxpayer to purchase stock that includes the right to receive (as a dividend) interest earned by the RIC during the period between the immediately preceding dividend declaration date and the date the taxpayer acquired the RIC stock. However, since, under our proposal, the taxpayer must hold the stock through a complete dividend declaration cycle, he will not be able to sell the stock and recognize a loss before there is a similar "build-up" of interest increasing the value of the stock. For example, if a taxpayer acquires stock of a RIC on August 15 and the RIC declares and pays dividends monthly on the last day of each month, the value of the RIC stock when purchased on August 15 will include interest earned by the RIC from August 1 through August 14. However, under our proposal, the taxpayer cannot sell the stock (without being subject to the loss disallowance rule) until September 15, and by that date there will be a "build-up" of earned but undistributed interest with respect to the stock just as there was on August 15 when the taxpayer purchased the stock. If the taxpayer sells the stock at that point, the interest that had "built-up" before he bought the stock should be at least roughly offset by the similar build-up of interest in the stock at the time he sold it.

shall be taxed at the highest corporate rate (currently 46 percent) with respect to any undistributed earnings.

In general, this change in the law reflects the belief that a RIC should not suffer the disastrous consequences of failing to qualify under Subchapter M solely by virtue of falling within the definition of a personal holding company. Rather, a more appropriate penalty, based on an undistributed earnings tax, was substituted in Subchapter M for RICs which may also be classified as personal holding companies.

Consistent with this policy and the 1984 Tax Reform Act's revisions of Subchapter M to delete the personal holding company prohibition, the Institute urges the repeal of Code section 852(a)(2). That provision of the Code states that a RIC may not qualify under Subchapter M unless, for each of its taxable years, the RIC complies with the Treasury regulations relating to ascertaining the actual ownership of the outstanding shares of stock of the RIC. As this provision was intended to assist the Secretary of the Treasury in determining whether a RIC was a personal holding company and, therefore, disqualified under Subchapter M, its original intent is no longer relevant. Moreover, its presence as a qualification requirement under Subchapter M is unduly harsh. Since a RIC is not disqualified under Subchapter M if it happens to be a personal holding company, a RIC which fails to fully comply with the regulations designed to determine personal holding company status should similarly not be disqualified under Subchapter M.

Although the Institute recommends deletion of this recordkeeping provision from the qualification tests of Subchapter M, we recognize that the status of a RIC as a personal holding company may still have some significance under amended section 852(b). Since, as mentioned above, a RIC which is also a personal holding will be taxed pursuant to section 852(b) at the highest corporate rate on undistributed earnings, it is not inappropriate for the Secretary of the Treasury to require that RICs obtain information relating to the actual ownership of the RIC's outstanding stock so that the Treasury can determine whether a RIC is in fact a personal holding company. However, since the 1984 Tax Reform Act changed the consequences of personal holding company status from disqualification under Subchapter M to the imposition of the maximum corporate tax on undistributed income, the Institute believes that the consequences of failing to comply with regulations proposed to assist the Treasury in determining personal holding company status should be modified in the same manner.

Accordingly, the Institute recommends that the requirements of Code section 852(a)(2) be moved to Code section 852(b)(1) so that a RIC which either meets the definition of a personal holding company or fails to comply with the Secretary's regulations relating to ascertaining the actual ownership of the RIC's outstanding stock would be taxed on any undistributed investment company taxable income at the highest corporate rate. Proposed statutory language to accomplish this change is attached hereto as Appendix B.

3) Proposed Amendment Relating to Code section 103(h)

As amended in the Tax Reform Act of 1984, Code section 103(h) denies tax-exempt status to the interest on municipal obligations the repayment of which is directly or indirectly guaranteed by the United States government or any agency or instrumentality thereof. Specifically, 103(h) denies tax exemption to an obligation if:

1) the payment of principal or interest on the obligation is directly or indirectly guaranteed (in whole or in part) by the United States or an agency or instrumentality thereof, or

2) the obligation is issued as part of an issue and a significant portion of the proceeds of the issue are invested directly or indirectly in federally insured deposits or accounts.

Two recent federal court decisions, *Philadelphia Gear Corporation* v. *Federal Deposit Insurance Corporation*, ___F. 2d___ (Nos. 84-1901, 84-2007 (10th Cir., 1984)) and *Allen et al*. v. *Federal Deposit Insurance Corporation*, ____ F. Supp. ____ No.

Civ. 3-84-274 (E.D. Tenn. Oct. 24, 1984) have given a new significance to these provisions of section 103(h). These cases have held that a standby letter of credit issued by a bank insured by the Federal Deposit Insurance Corporation ("FDIC") constitutes an FDIC-insured "deposit" within the meaning of the Federal Deposit Insurance Act, 12 U.S.C. section 1811 et seq. Thus, questions have been raised as to whether the interest on certain municipal obligations secured by a letter of credit from an FDIC-insured bank would be denied exemption from federal income tax under Code section 103(h).

The immediacy of this problem has been temporarily postponed by an IRS Release (See IR-85-42, dated April 26, 1985), which grandfathers the tax-exempt status of obligations backed by letters of credit of FDIC-insured banks and issued before December 31, 1985. However, the Institute, on behalf of its municipal bond fund members, believes that permanent legislative relief is necessary to clarify the status of these letter of credit-backed obligations issued after December 31, 1985.

The Institute suggests that the conditions for denying tax exemption under Code section 103(h) should be clarified to apply in only those instances where a municipal obligation was marketed and purchased in reliance upon the existence of a federal guarantee. In the case of a mutual fund designed to invest in tax-exempt obligations,* the fund does not rely upon the possible availablity of $100,000 of FDIC insurance coverage with respect to one or more of the obligations in its portfolio. Such obligations are not typically rated or marketed to mutual funds on the basis of the possible existence of federal deposit insurance. Therefore, tax-exempt obligations held by mutual funds should not fall within the definition of a "federally guaranteed" obligations under Code section 103(h). The scope of the definition of "federally guaranteed" obligations should be narrowed to reflect only the abusive situations intended to be cured by the Tax Reform Act, not others which may be covered as a result of the recent judicial decisions mentioned above. We would be pleased to work with the Committee or its staff to develop appropriate legislative language to accomplish this result.

(4) Diversification Requirements Applicable to Variable Annuity Contracts - Code section 817(h)

The Tax Reform Act of 1984 amended Code section 817 to provide diversification requirements applicable to variable insurance contracts. In general these provisions state that, the Secretary of the Treasury may prescribe diversification requirements applicable to variable contracts; however, the statute itself also provides a diversification safe harbor. Pursuant to the statutory safe harbor, a variable annuity contract will be treated as adequately diversified if it meets the diversification requirements applicable to RICs under Code section 851(b)(4) and the fund has no more than 55 percent of its assets invested in cash, cash items, government securities and securities of other RICs.

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*At the present time, Institute statistics indicate that municipal bond funds hold approximately $60 billion worth of obligations exempt from tax under Code section 103(a).

The safe harbor specifically permits a variable annuity contract which is based upon a fund, 55 percent of which may be invested in the stock of another RIC, including, presumably, a RIC whose shares are available for sale to the public. Unfortunately, this measure, intended to permit the marketing of a variable annuity funded in part with RIC stock whose shares are available for sale to the public, has had no impact. The safe harbor provision is entirely impractical and unworkable. To our knowledge no variable annuity product in existence today is based up a fund owning a significant percentage of shares of another RIC which is offered to the public.

The Institute believes that the diversification safe harbor provision included in the 1984 Tax Reform Act should be clarified to permit a variable annuity to be fully funded through a mutual fund, the shares of which are available for sale to the public. Absent such a provision, current law creates a discrimination within the mutual fund industry between mutual fund sponsors affiliated with life insurance companies and those which are not. Mutual funds affiliated with insurance companies may sponsor the dedicated funds upon which variable products must currently be based. However, mutual funds not affiliated with an insurance company may not, as a practical matter, join with an unaffiliated life insurance company to offer a variable annuity product.

The reasons for distinguishing between variable annuities funded through a dedicated mutual fund and those based upon funds whose shares are available for sale to the public no longer exist. Both mutual funds available to the public and those dedicated funds currently serving as the basis of variable annuity contracts are subject to the requirements of the Investment Company Act of 1940. Moreover, with the enactment of TEFRA and the Tax Reform Act of 1984, significant further restrictions have been placed on deferred annuities. There is no further need for additional tax law provisions differentiating between direct investment and long-term investment through annuities.

With the tax law concerns distinguishing between annuities and direct investment incorporated into law, Congress should correct the unwarranted discrimination within the mutual fund industry between mutual funds affiliated with insurance companies and those which are not. The diversification safe harbor set forth in Code section 817 pursuant to the Tax Reform Act should be expanded to permit a mutual fund whose shares are available for sale to the public to fully fund a variable insurance contract rather than permitting only 55 percent of the underlying funding vehicle to include shares of a publicly-offered mutual fund. The proposed amendment to Code section 817 which is set forth in Appendix C would correct and clarify the safe harbor provision of that section by permitting the use of a publicly-offered mutual fund as the funding vehicle for variable insurance products.

5) H. R. 2110 Technical Corrections to the Retirement Equity Act --The Requirement to Purchase a Commercial Annuity

It has recently come to the Institute's attention that the Internal Revenue Service ("IRS") may be interpreting the joint and survivor and preretirement survivor annuity requirements of Code sections 401(a)(11) and 417, as amended by the Retirement Equity Act, in a manner that would require that certain defined contribution retirement plans provide for the purchase of commercial annuity. The Institute believes that such an interpretation is not justified under either the specific language or intent of the Retirement Equity Act and that statutory or Committee Report language clarifying this point are highly desirable.

As revised by the Retirement Equity Act, section 401(a)(11) of the Code requires that certain defined contributions plans* provide benefits in the form of a "qualified joint and Survivor annuity" and also provide death benefits in the form of a "qualified preretirement survivor annuity". Both of these forms of benefits are described in Code section 417.

Section 417(b) of the Code defines a "qualified joint and survivor annuity" as:

> "... an annuity -
>
> (1) for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity which is payable during the joint lives of the participant and spouse, and
>
> (2) which is the actuarial equivalent of a single annuity for the life of the participant.
>
> Such term also includes any annuity in a form having the effect of an annuity described in the preceding sentence."[emphasis added]

Section 417(c)(2) of the Code defines a "qualified preretirement survivor annuity" for a defined contribution plan as, "an annuity for the life of the surviving spouse the actuarial equivalent of which is no less than 50 percent of the account balance of the participant as of the date of death."

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*This requirement extends to essentially all defined contribution retirement plans other than those profit-sharing plans which automatically provide for the participant's accrued, vested benefit to be paid to his or her surviving spouse in the event of death.

Prior to the revision of the joint and survivor rules by the Retirement Equity Act of 1984, most defined contribution plans satisfied the joint and survivor rules without having to offer the purchase of an annuity contract. This was accomplished by paying out the participant's account balance upon death after the participant attained early retirement age.

Although we recognize that the recent changes to the joint and survivor rules reflect an intent to require defined contribution pension plans to provide greater protection for participants' spouses than was previously required, we believe that this protection can be accomplished without the purchase of a commercial annuity contract from an insurance company. Moreover, we believe that statutory language cited above, specifically permits plans to provide the required joint and survivor protection through means that would not contravene a participant's chosen investment medium.

However, in light of a recent IRS interpretation of these requirements* Institute recommends that the Retirement Equity Act be clarified. Specifically, we urge the adoption of either statutory or Committee Report language providing that an annuity from a defined contribution plan will be considered a "qualified joint and survivor annuity" if it meets the following requirement:

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*IRS LRMs (model language) issued for use in master and prototype plans have required that certain defined contribution plans provide for the purchase of a commercial annuity to satisfy the joint and survivor and preretirement survivor annuity definitions.

- o the payment in any year does not exceed the the value of the account balance at the beginning of that year divided by the joint and last survivor life expectancy of the participant and spouse, based on the ages of those individuals at the beginning of that year.

Similarly, we propose that the Retirement Equity Act be revised to clearly indicate that an annuity from a defined contribution plan will be considered a "qualified preretirement survivor annuity" if it meets the following requirements:

- o at least 50 percent of the participant's account balance at death is used to provide an annuity to the spouse; and
- o the payment in any year does not exceed the the remaining death benefit at the beginning of that year divided by the spouse's life expectancy, based on the spouse's age at the beginning of the year.

The joint and survivor rules were enacted to provide extra protection to the spouses of plan participants in their retirement years. This assurance of retirement income can be adequately provided under our proposal, without the purchase of a commercial annuity contract.

Attached hereto as Appendix D are three exhibits which we believe demonstrate the adequacy of the survivor's benefits that would be provided under the Institute's proposal. Tables 1, 2, and 3 show the annual distribution that would be made under our proposal to a participant who retires at age 65 with a spouse who is five years younger. The tables assume a fund with an annual return of 3 percent 5, percent, and 7 percent, respectively.* Note that, regardless of the funds' earnings, the payments continue at a significant level for many years. Assuming a 5 percent fund annual return, the annual payment will not drop under 50 percent of the initial payment until the spouse has attained age 102. Furthermore, the payment in year 36 exceeds the amount paid in the first year.

Reviewing these projections, we believe that our proposal is consistent with the policy objective of providing significant protection for participants' spouses. Similar patterns would result in the case of the preretirement survivor annuity. In that case, however, there should even be less concern, because the spouse will not be "sharing" the distribution with any other beneficiaries.

In addition, an interpretation of the provisions of the Retirement Equity Act which would require that plans provide for the purchase of a commercial annuity represents a governmental intrusion into the marketplace which would have an unfair competitive effect on the mutual fund industry. If certain defined contribution plans invested in mutual funds are required to offer benefits in the form of an insurance company annuity contract, significant amounts will have to be withdrawn from mutual funds for the purchase of annuity contracts. Plan participants would be denied the opportunity to fund their retirement plan through their preferred investment medium.

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*From 1979 to the present, the average annual return on money market funds has ranged between a low of 8.58 percent and a high of 16.82 percent. (From Donoghue's Money Fund Report.) For the past ten years common stock mutual funds have performed at an average annual rate of about 15 percent, and for the past twenty-five years common stock funds have performed at an average annual rate of about 9.2 percent.

For these reasons, the Institute urges the adoption of the proposal set forth above to clarify the joint and survivor and preretirement survivor annuity requirements of the Retirement Equity Act.

* * * *

The Institute appreciates the opportunity to present these comments to the Committee. Please contact us if you have any questions regarding these proposals.

IVINS, PHILLIPS & BARKER
CHARTERED
1700 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006

RICHARD B. BARKER
KARL R. PRICE
JOHN C. REID
JAY W. GLASMANN
JOSEPH E. MCANDREWS
H. STEWART DUNN, JR.
CARROLL J. SAVAGE
ERIC R. FOX
WILLIAM L. BOLLES
CAROL K. NICKEL
NORA A. BAILEY
LESLIE JAY SCHNEIDER
WILLIAM R. REITER
KEVIN P. O'BRIEN
MICHAEL F. SOLOMON
PHILIP D. MORRISON

WILLIAM W. CHIP
PATRICK J. SMITH
DANIEL B. STONE
MICHAEL R. HUFFSTETLER
ROBERT H. SCARBOROUGH
R. LEE CHRISTIE
EILEEN F. SERENE

JAMES S. Y. IVINS ([illegible])
PERCY W. PHILLIPS ([illegible])

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TELEPHONE 393-7600

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248796

April 10, 1985

Melvin C. Thomas, Esq.
Joint Committee on Taxation
1012 Longworth House Office Building
Washington, D.C. 20515

Fairlea A. Sheehy, Esq.
Department of Treasury
Room 4108
Washington, D.C. 20220

Re: Technical Corrections - Section 7872

Dear Mel and Fairlea:

I was pleased to see in the proposed "Technical Corrections Act of 1985" (H.R.1800 and S.814) the technical amendments making it clear that there is to be no wage withholding under Chapter 24 with respect to either demand or term loans under § 7872 as well as the broadening of regulatory authority to provide that any loan with an indefinite maturity may be treated as a demand loan. One technical correction that I expected to see, however, was not included.

As you may recall, the statute requires that, for a loan to be treated as a deemed demand loan, the loan must be nontransferable and the interest rate benefit must be conditioned on the future performance of substantial services by an individual.*/ The legislative history, however, stated that the interest rate benefit only was to be subject to these two conditions.**/ The Joint Committee's "Bluebook" points out this discrepancy, reiterates Congress's intent that the employee's interest rate benefit, rather than the entire loan, must be nontransferable, and states that a technical amendment may be necessary to effectuate this intent.***/

It seems a fairly simple matter to amend the second sentence of § 7872(f)(5) to effectuate Congress's clear intent. I would suggest the following:

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*/ Internal Revenue Code § 7872(f)(5):

"(5) DEMAND LOAN. - The term 'demand loan' means any loan which is payable in full at any time on the demand of the lender. Such term also includes (for purposes other than determining the applicable Federal rate under paragraph (2)) any loan which is not transferable and the benefits of the interest arrangements of which is conditioned on the future performance of substantial services by an individual."

**/ Statement of Managers, Conference Report for Deficit Reduction Act of 1984, H.R.Rpt. 98-861 (June 23, 1984), at page 1018:

"For purposes of determining the timing and amount of the transfers deemed made under the provision, a compensation related term loan is treated as a demand loan if the benefit derived by the employee from the interest arrangement is (1) nontransferable and (2) conditioned upon the future performance of substantial services by the employee."

***/General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84, December 31, 1984), at pages 533-534:

"The Congress intended that a loan be treated as nontransferable if the benefit derived by the employee from the interest arrangement cannot be transferred by the employee. A technical amendment may be necessary to effectuate this intent."

> "Such term also includes (for purposes other than determining the applicable federal rate under paragraph (2)) any loan the benefits of the interest arrangements of which are not transferable and are conditioned on the future performance of substantial services by an individual."

This seems to me a simpler and far less confusing means for solving the problem than leaving it to regulations to adopt a non-common-sensical definition of what it means for a loan to be nontransferable. While the Treasury may have the authority to declare in regulations that a loan would be treated as nontransferable if the benefit derived by the employee in the interest arrangement cannot be transferred, a technical correction to the statute itself seems the far more direct and clear route.

This change is of some importance to Employee Relocation Council members since some employer-provided, relocation mortgage loans may be assumable. Under the statute as presently drafted, an assumable mortgage loan could not, of course, qualify as a deemed demand loan. With the proposed change, however, an assumable term loan could be deemed a demand loan provided that the below-AFR interest rate were not itself assumable.

If you have any questions about this matter or disagree with my conclusion that a technical correction is warranted, I would greatly appreciate a call.

Sincerely,

Philip D. Morrison

cc: Mr. H. Cris Collie

Knights of Columbus

OFFICE OF TAX COUNSEL • WILLIAM J. LEHRFELD
1301 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. 20004 • (202) 659-4772

June 12, 1985

Honorable Bob Packwood, Chairman
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: S. 814 (The Technical Amendments Act of 1985) Hearing held June 5, 1985

Dear Mr. Chairman:

This letter is sent on behalf of the Knights of Columbus of New Haven, Connecticut, a fraternal benefit society described in Section 501(c)(8) of the Internal Revenue Code of 1954, as amended. The Knights of Columbus is an international society of Catholic men, dedicated to strong family values, enhancement of our Church, and such ideals as charity, unity, fraternity and patriotism. Its benefit program gives over 1.3 million members in the United States the opportunity to purchase for themselves (or their wives or dependents), individual life, sick or accident policies from a society dedicated to his needs and values.

We are requesting clarification of Section 128 of S. 814, The Technical Corrections Act of 1985, to affirmatively provide nonrecognition of gain treatment under Code Section 1035 for exchanges made by policyholders of insurance

SUPREME OFFICE • COLUMBUS PLAZA • NEW HAVEN, CONNECTICUT 06507 • (203) 772-2130

issued by fraternal organizations. Such a clarification would fulfill the 1984 intent of Congress for nonrecognition treatment of all types of policy exchanges based on the type of policy issued rather than the issuing company's taxable or tax-exempt status. Thus, policies of fraternal benefit societies and similar 501(c) insurance organizations should be explicitly mentioned in the Code, or in the Committee Reports, as specifically eligible for Section 1035 nonrecognition.

A. Current Law Under I.R.C. Section 1035

Section 1035 was enacted in 1954 as part of the Internal Revenue Code's general revision, to allow a taxpayer to exchange one insurance policy for another insurance policy, without recognizing gain or loss. The House Report stated that the purpose of the statute was to overrule decisions under prior law, which had taxed gain putatively realized on exchanges of various types of insurance policies, even though the taxpayer had received no cash (H. Rep. No. 1337, 83d Cong., 2d Sess., 80 (1954)):

> Under present law, where one insurance policy is exchanged for another, the excess of the value of the policy received over the premiums paid for the exchanged policy is taxable. This has resulted in the taxation of individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain.

The "present law" referred to was represented by Parsons v. Commissioner, 16 T.C. 256 (1951).

The 1954 change defined the contracts of insurance to which the exemption statute applied as "contract[s] with a life insurance company as defined in section 801 which depends in part on the life expectancy of the insured * * * *" (emphasis added.)

Under the terms of that statute, and the administrative interpretations which followed, nonrecognition was also accorded a taxpayer's exchange of a qualifying policy issued by one company for a qualifying policy issued by another company. Rev. Rul. 72-358, 1972-2 C.B. 473; Rev. Rul. 73-124, 1973-1 C.B. 200. The main requirement was that the insured remain the same under both policies. Ibid; Treasury Regulations, § 1.1035-1(c).

Under the 1954 law, the Internal Revenue Service appears to have broadly interpreted the statutory phrase "contract with a life insurance company as defined in section 801." (Emphasis added.) For example, in Private Letter Ruling 8442010, it held that a taxpayer who exchanged an annuity insurance policy issued by a savings bank, for a similar annuity insurance policy issued by a commercial insurance company, satisfied the above-quoted provision in the statute. The Ruling reasoned that if the insurance department had not been part of the savings bank, and had not been governed by the special rules for savings bank insurance (e.g., Code Section 594), the insurance department would have been taxed as an insurance company under Section 801. Accordingly, it was held that an insurance contract issued by a savings bank qualified for nonrecognition under Section 1035 when upgraded and re-issued by a commercial carrier.

We believe that similar reasoning would have allowed contracts issued by the life insurance departments of fraternal organizations to satisfy the Section 1035 phrase "contract with a life insurance company as defined in section 801", under prior law but our view remains untested administratively. We are certain, however, that if a fraternal society's life insurance department were a separate taxable entity not governed by Section 501(c)(8), it would have been "a life insurance company as defined in section 801," the standard from 1954 to 1984.

The Deficit Reduction Act of 1984 amended the definition of endowment and life insurance contracts eligible for Section 1035 nonrecognition treatment. The law now permits those contracts issued by any insurance company taxable under subchapter L to be exchanged by an individual without the owner being taxed on the previously accrued earnings on his prior policy. Section 224 of the 1984 Act sought to re-focus the tax-free exchange rule on the benefits of the policy rather than on the tax status of the company which is issuing the new policy. Its intent was to expand the class of newly issued contracts which qualified the owner for nonrecognition of gain from his old policy.[1] Thus, Section 1035, as now in force, gives nonrecognition treatment not just to qualifying contracts issued by Section 801 stock life insurance companies, but also to qualifying contracts issued by other types of insurance companies taxed under subchapter L (e.g., mutual life insurance companies). See S. Rep. 98-169, 98th Cong., 2d Sess., 581 (1984); H. Rep. 98-861, 98th Cong., 2d Sess., 1078-1079 (1984).

B. Section 1035 Treatment and Fraternal Benefit Societies

The reports of the Tax Committees on the 1984 legislation, cited above, do not address the question of equivalent treatment for individuals who are members of nonprofit benefit organizations which issue benefit contracts having similar characteristics as commercially issued policies, despite substantial comparability of purpose. As your technical corrections proposal stands now, Section 1035 nonrecognition will become available for exchanges of life or annuity contracts by policy holders but only if offered by "insurance companies". S. 814 would change the reference so that such companies no longer need be "subject to tax under subchapter L." It is true that societies such as the Knights of Columbus could be considered insurance companies for this purpose, as the Joint Committees "Description" of proposed Sec. 128 (of S. 814) suggests.[2] However, the fact is that fraternals have never been regarded by the Internal Revenue Service as true insurance companies but rather as benevolent organizations, serving communities, families, and churches, as well as its members who are owners of benefit contracts.[3]

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[1] "The Act amends the definition of an endowment contract and a life insurance contract to include contracts issued by any insurance company taxable under subchapter L of the Code, rather than just by life insurance companies." General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Joint Committee Staff Publication, December 3, 1984 at p.661.

We foresee a revenue agent examining a member's income tax return of a member who exchanged policies being denied Section 1035 relief, even if Sec. 128 is enacted to modify Section 1035. After all, exemptions from tax are narrowly construed and an examining agent would expect that Congress to address the question of nonprofit issuers of covered policies by statute and with precision.

Tax-free treatment for fraternal policies is as important to us as it is to the issuers of "traditional" insurance policies. There are many occasions where policyholders of fraternal benefit societies need to exchange an old policy for a new policy. For example, holders of juvenile life insurance policies often issued in face amounts of $500 or $1,000 frequently exchange them for larger policies when they reach adulthood, or when they marry and have their own children and "trade up." Another common example is where a member's wife-beneficiary predeceases him, so the member exchanges his life insurance policy for an annuity policy to pay himself old-age benefits. In addition, older, fixed-premium policies are frequently exchanged for more modern, flexible premium policies.

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[2] Cf. "Description of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814), Joint Committee Staff Document, April 4, 1985, at pp.76-77. "The bill amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code."

[3] In O.D. 690, C.B. No. 3, 236 (1920), IRS stated: "A fraternal beneficiary association may be a mutual insurance company, but must be something more. It must be primarily fraternal * * *."

Apparently, Congress sought to treat those and other policy exchanges by members of fraternal societies as eligible for nonrecognition treatment in the 1984 law and in the current version of the 1985 technical correction proposal. Although a fraternal benefit society is not now expressly characterized as an "insurance company" under the existing Code provisions, considerations of tax equity should assure the same nonrecognition of gain treatment for our members as is now explicitly given to the issuance of a new policy by a commercial insurance company.[4]

For these reasons, we urge you to consider enlarging Section 128 of the Technical Amendments Act of 1985, by adding a reference to 501(c) organizations. Failing that, an example of how fraternal society members benefit from the amended I.R.C. Section 1035(b)(1) in the pertinent Committee report would be almost as helpful. By so doing, our members will be assured of nonrecognition treatment on exchanges, in line with the 1984 Congressional intent and the intent of your 1985 technical correction.

There should be no revenue affect to this change and we believe the Office of Tax Legislative Counsel of the Treasury Department would not object to it.

Sincerely yours,

William J. Lehrfeld

WJL:ld

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[4] Even if the Knights of Columbus was subject to the same state regulations as for-profit carriers, and so would be characterized as an "insurance company" by the various states which regulate fraternal insurance, IRS could disregard that characterization for federal tax purposes because of national policy considerations. See GCM 6782, C.B. VIII-2, 209 (1929), where IRS holds that a carrier's status under the states' insurance laws is not conclusive and binding for federal tax purposes.

WINSTON & STRAWN
SUITE 500
2550 M STREET, N.W.
WASHINGTON, D.C. 20037
202 828-8400
TELEX 6971734
TELECOPIER 202 828-8473

JOHN R. REILLY
DEAN L. OVERMAN
CHESTER W. NOSAL
HURD BARUCH
EDWARD C. MAEDER
JOHN G. MILLIKEN
JOHN R. KEYS, JR.
PETER N. KYROS, JR.
KENNETH BERLIN
RICHARD MELTZER

PAUL C. FIDUCCIA
MICHELLE K. GARY
EDWARD F. GERWIN, JR.
PAUL BOUSQUET
SUSAN K. SHAPIRO
ANN WOODLEY HARBOTTLE
J. BLAIR RICHARDSON, JR.
THOMAS A. DEVINE

WALTER F. MONDALE
OF COUNSEL

CHICAGO OFFICE
ONE FIRST NATIONAL PLAZA
CHICAGO, ILLINOIS 60603
312 558-5600

PHOENIX OFFICE
3101 NORTH CENTRAL AVENUE
1500 SOUTHWEST FINANCIAL PLAZA
PHOENIX, ARIZONA 85012
602 277-1776

FREDERICK H. WINSTON (1853-1886)
SILAS H. STRAWN (1891-1946)

May 17, 1985

Ms. Betty Scott-Boom
Committee on Finance
United States Senate
Washington, DC 20510

Dear Ms. Scott-Boom:

Enclosed please find the original and five (5) copies of the written statement of La Choy Food Products concerning S. 814, The Technical Corrections Act of 1985. La Choy submits this statement for inclusion in the printed record of the hearing on this proposed legislation.

Sincerely,

Paul Bousquet
Paul Bousquet
Counsel to La Choy Food Products

PB/pc

Encls.

S.814

STATEMENT OF LA CHOY FOOD PRODUCTS

La Choy Food Products, a subsidiary of the Beatrice Companies, Inc., and a major importer of processed oriental vegetables, strongly supports S.814, Section 228 of which would make the elimination of tariffs on certain imported vegetables retroactive to June 30, 1983.

Section 115 of the Trade and Tariff Act of 1984 permanently removed the tariff duty on imported processed water chestnuts and bamboo shoots. The legislative intent clearly was to make that elimination retroactive to June 30, 1983, the date the prior three-year suspension of the tariff duty terminated. The Conference Report states that the Act "[p]rovides for permanent column 1 duty-free treatment for water chestnuts and bamboo shoots retroactive to June 30, 1983." H.R. Rep. No. 98-1156, 98th Cong., 2nd Sess. 104 (1984). The retroactivity provision, however, inadvertently was omitted from the final version of the Act, along with retroactivity provisions intended to be applicable to four other tariff modification sections (Sections 112, 118, 167, and 169).

A colloquy on the House floor between Representatives Frenzel and Kazen in the final days of the last Congress also indicated that this oversight was inadvertent and that the Ways and Means Committee would take the first opportunity in the present Congress to correct the oversight. 130 Cong. Rec. 12,283-84 (October 12, 1984).

On November 29, 1984, Senator Danforth, Chairman of the Subcommittee on International Trade of the Committee on Finance, and Representative Gibbons, Chairman of the Subcommittee on Trade of the Ways and Means Committee, sent a joint letter to William von Raab, Commissioner of the U.S. Customs Service, informing the Commissioner of the congressional intent to remedy this oversight by introducing technical correction legislation in the present Congress.

Failure to enact the technical correction legislation would result in an anomalous situation in which processed water chestnuts and bamboo shoots imported between June 30, 1983, and November 14, 1984 (the effective date of the Trade and Tariff Act of 1984) would be subject to duty, while the same articles imported either prior or subsequent to that period would not be dutiable. Failure to enact the technical correction legislation, moreover, would result in substantial cost and inconvenience to firms situated like La Choy. Some of these costs undoubtedly would be passed on to consumers in the form of higher prices.

John G. Milliken
Paul Bousquet
Winston & Strawn
Suite 500
2550 M Street, N.W.
Washington, D.C. 20037
(202)828-8400
Counsel to La Choy Food Products

Statement
before the
Senate Finance Committee
on the
Technical Corrections Act of 1985 (S. 814)

submitted by
Paul H. Lane
General Manager
Department of Water and Power of
The City of Los Angeles
on
June 5, 1985

Mr. Chairman, the following statement is meant to clarify an issue on which the Committee took a firm stand during the deliberations in respect of the Tax Reform Act of 1984, but which has subsequently become clouded by certain provisions of the proposed Technical Corrections Act of 1985 (S. 814). Specifically, I refer to the financing of the Mead-Phoenix Project.

The Mead-Phoenix Project is a joint participation project of public bodies in California and Arizona, and the Western Area Power Administration of the United States Department of Energy (which I refer to as Western). The participants in California are the Southern California Public Power Authority, acting for the Cities of Los Angeles, Anaheim, Azusa, Banning, Burbank, Colton, Glendale, Pasadena, Riverside and Vernon; and the M-S-R Public Power Agency, acting for the Cities of Santa Clara and Redding and the Modesto Irrigation District. The Arizona public body is the Salt River Project Agricultural Improvement and Power District in Phoenix, Arizona.

The Mead-Phoenix Project will be a high-voltage direct current transmission line which will enable the participants to make economical energy purchases and transfers through increased transmission capability, and will assist Western in meeting energy delivery requirements to its wholesale customers as required by federal law. The preliminary estimate of construction costs of the Mead-Phoenix Project is approximately $500 million. It is estimated that the Project will be in service in 1990.

During the deliberations on the Tax Reform Act of 1984, it was brought to the Committee's attention that further tax-exempt financing of this valuable project was jeopardized as a result of the prohibition on federal guarantees contained in that Act. The concern was that the participation of Western might be viewed as a prohibited federal guarantee. In light of the value of the Project to the project participants, including Western, and the financial commitments which had been previously made, including a $14.1 million issue of notes to finance development and related costs of the Project, a specific "grandfathering" clause was included in the 1984 Tax Act to preserve tax exemption for interest on obligations to finance the

Mead-Phoenix Project. This grandfather provision was included as Section 632(d) of the 1984 Tax Act.

Accordingly, the Committee and the Congress have already considered the Mead-Phoenix Project and have taken action in the 1984 Tax Act specifically to preserve the tax exemption of interest on obligations issued with respect to the Mead-Phoenix Project, notwithstanding the participation of Western.

Although the Congress protected the Mead-Phoenix Project in the 1984 Tax Act, a provision of the Technical Corrections Act of 1985 (which, as you know, amends the 1984 Tax Act) would undermine that protection. This undermining would occur because the bonds to finance the Mead-Phoenix Project could, under the Technical Corrections Act, run afoul of the "consumer loan bonds" provisions.

Beside dealing with "federal guarantees" and other issues, the 1984 Tax Act added Section 103(o) to the Code, providing that interest on obligations would not be tax-exempt if they are "consumer loan bonds." Section 103(o) of the Code provides that a bond is a taxable consumer loan bond if five (5%) percent or more of the proceeds are reasonably expected to be used, directly or indirectly, to make loans to non-exempt persons. Such non-exempt persons would include the federal government, including Western. Western is the only non-exempt person participating in the Mead-Phoenix Project, but it has taken a twenty percent (20%) interest in the Mead-Phoenix Project.

When the 1984 Tax Act was passed, the consumer loan bond provisions did not apply to the Mead-Phoenix Project. Among the transitional rules contained in the 1984 Tax Act was Section 631(c)(3) which provided that the amendments made by the 1984 Tax Act did not apply to obligations with respect to facilities "with respect to which a binding contract to incur significant expenditures was entered into by October 19, 1983." Because of the contractual arrangements previously entered into by the participants with respect to the Mead-Phoenix Project, even if the arrangements with Western (the only non-exempt person involved) produced "consumer loan bonds", the transitional rule provisions of Section 631(c)(3) made the consumer loan bond provisions inapplicable to the Mead-Phoenix Project.

The problem arises now, however, because Section 169 of the Technical Corrections Act would revise the transitional rule set forth in Section 631(c)(3) of the 1984 Tax Act so that the consumer loan bond provisions of Section 103(o) of the Code would apply to the financing of the Mead-Phoenix Project. As a result, if the arrangements with Western were to be treated as a loan for tax purposes, interest on bonds issued by Southern California Public Power Authority to finance the Mead-Phoenix Project would not be tax-exempt. Accordingly, the protection of the tax-exempt status of bonds for the Mead-Phoenix Project specifically approved by Congress in Section 632(d) of the 1984 Tax Act would be negated by a "technical correction", to the same Act. Further, as discussed in previous testimony to the Committee, absence of the tax exemption could well cause abandonment of the Mead-Phoenix Project.

Because it was clearly the intent of the Congress when it enacted the Tax Reform Act of 1984 to specifically preserve the tax exemption of interest on obligations issued for the Mead-Phoenix Project, we feel it is reasonable to expect Congress to preserve this exemption in the technical amendments.

I appreciate your consideration of this matter and we want to cooperate with the Committee in finding a feasible solution to this problem. To this end I would like to suggest the accompanying language, which is similar to the existing Mead-Phoenix Project "federal guarantee" grandfather clause, and would continue the exclusion of obligations issued by Southern California Public Power Authority for the Mead-Phoenix Project from the consumer loan bond provisions.

ANNEX A

The following would be added to Section 170 of The Technical Corrections Act of 1985:

AMENDMENTS RELATED TO SECTION 632 OF THE ACT

* * *

Subsection (d) of Section 632 of the Tax Reform Act of 1984 is amended -

(1) by deleting the "." at the end of the subsection heading and adding in lieu thereof ", ETC."; and

(2) by deleting all words prior to paragraph (A) and adding in lieu thereof

> "Obligations (including refunding obligations) shall not be subject to sections 103(h) or 103(o) of the Internal Revenue Code of 1954 if -".

Statement of Ethan Lipsig on Behalf of Lockheed Corporation, Northrop Corporation, Baker International Corporation and TRW on S. 814, Making Technical Corrections to The Retirement Equity Act

I. Introduction

This statement is being made on behalf of four major companies employing more than a quarter of a million workers. While these companies generally support S. 814, which would make technical corrections to the Retirement Equity Act ("REA"), there are a number of provisions in S. 814 which are extremely disturbing and go far beyond being mere "technical" corrections. In addition, a number of needed changes have not been proposed.

Our concerns fall into three categories: (1) substantive changes in law which should be deleted from the bill; (2) technical corrections which have not been proposed but which should be made; and (3) proposed technical corrections which should be adopted in modified form. These three categories are discussed seriatim.

II. Substantive Changes That Should Not Be Made

S. 814 contains a number of substantive changes in the law which are being proposed as mere "technical" corrections. Because of the tremendous impact that these changes will have, we think it is inappropriate for them to be adopted in the context of a technical correction bill without careful consideration of all their ramifications. These provisions are as follows:

(a) Proposed Change to Class Year Vesting

The most dramatic example of a substantive change in the technical corrections bill is the provision which for the very first time would extend some of ERISA's break in service concepts to class year vesting plans. A "class year" vesting plan is a defined contribution plan under which each year's contribution vests independently. For example, contributions for a given year vest at the end of the fifth following year (this is the maximum vesting period allowable in class year plans). In contrast to the five year maximum allowable under class year plans, a wait of up to fifteen years before benefits fully vest is permitted under conventional vesting provisions. As the quid pro quo for faster vesting, class year plans were not required by ERISA to comply with any of the following vesting rules:

1. Counting hours of service
2. Counting years of service
3. Counting break in service years
4. Counting years before a person became a participant in the plan
5. Counting service with affiliates
6. Waiting for a break in service year before forfeiting benefits
7. Counting prior service after rehire (except if a "parity" break has occurred)

REA modified the ERISA rule which generally prohibited a defined contribution plan from forfeiting benefits until a break in service year had occurred. This modification consisted of prohibiting forfeitures until five consecutive break in service years had occurred. Since class year plans were never subject to the one year ERISA rule, they were not subject to the five year modification of that rule.

The proposed technical corrections bill would for the very first time impose an ERISA break in service rule on class year plans. It would do this by establishing a "break in service" concept for class year plan purposes and would make a class year plan wait for five consecutive break years before it could forfeit an unvested benefit. This change would unquestionably make class year plans more like conventional plans and that is the very reason why this change should not be adopted. Class year plans are supposed to be different from other plans. Because of their shorter vesting requirements, they were exempted from all the ERISA vesting requirements listed above. S. 814 would change all this by making class year plans subject, in effect, to conventional vesting requirements.

The proposed change is also untimely. Employers have spent millions of dollars complying with REA. This one change would require virtually every of the many class year plans in this country to be amended and resubmitted to the Internal Revenue Service and would require summary plan description updates.

In short, the proposed class year vesting rule should not be adopted. It is not a technical correction, it constitutes piecemeal tinkering with a complex statutory scheme and its untimely adoption will be very burdensome.

(b) Proposed Changes to the Joint and Survivor Annuity Provisions

The proposed technical corrections bill would in two ways extend the spousal consent requirements imposed by REA on plans subject to the joint and survivor rules. First, it would require spousal consent to the pledge of plan benefits as security for a participant loan. Second, it would require that spousal consents to waivers of post retirement survivor annuity benefits also include consents to the designation of beneficiaries under the alternative form of benefit chosen (if it provides for a death benefit).

Neither of these two consent requirements would have been particularly objectionable had they been included in REA. However, they were not included in REA and establishment of these two spousal consent requirements at the present time will impose a serious burden on employers. Once again, they will have to amend plans, plan descriptions and administrative forms to comply with these two new requirements.

These new requirements will not provide significant protection to spouses. First, only a very small percentage of the employee population is covered by plans which are subject to joint and survivor requirements and which permit loans. Second, spouses are already required to acknowledge the effect of their consents to waivers of post retirement survivor benefits in order for the consents to be valid. Many employers interpret this acknowledgement requirement to require that the spouse also consent to the alternate form of benefit chosen and the designation of beneficiaries under it. These employers reason that, absent consent to the form actually chosen and the beneficiary designated, it would be hard to prove that the spouse truly understood the effect of his or her consent. Thus, there is no practical need to require that spouses consent to beneficiary designation because many employers already require this anyway.

Our objection to these proposed spousal consent requirements is primarily that they are not timely and that compliance would, therefore, be burdensome. In view of the very limited benefits that would be derived from them, we urge that these requirements be eliminated entirely. However, if these requirements must be enacted, we urge that employers be given ample time to comply with these additional requirements so as not to burden them unduly. For example, compliance might be required at the time a plan is otherwise amended after enactment of this bill, but with a maximum compliance deadline of January 1, 1988.

(c) Qualified Domestic Relations Orders

S. 814 would change two provisions relating to the qualified domestic relations order ("QDRO") rules in REA. The QDRO provisions are widely supported by employers. These rules permit employers and plans to deal with divorce orders and other support decrees in an efficient and equitable fashion. The two technical corrections proposed to the QDRO provisions would seriously erode this benefit.

The first such change is a provision which would make the participant taxable on amounts paid to an alternate payee (other than spouse or former spouse). The clear and unambiguous rule under REA was that the alternate payee was to be taxed on the distribution whether the alternate payee was a spouse or not.

The proposed change will be difficult to enforce and difficult to explain to participants. Why should they have to pay money on a retirement plan distribution made to someone else? The constructive receipt rules in Section 402 of the Internal Revenue Code (governing taxation of pension benefits) were repealed a number of years ago and Section 402 currently imposes tax liability on "any distributee" of benefits. Tax liability should follow the money and this change to REA should not be made.

The second change to the QDRO rules is even more troublesome. This rule would prohibit a plan from complying with a qualified domestic relations order to the extent it required more than a de minimis distribution before the amount could otherwise be properly paid to the participant. Thus, until an employee reaches retirement age, for example, a pension plan could not follow a QDRO requiring that payments be made to a spouse or child, no matter how needy the spouse or child was. There simply is no sound policy reason for prohibiting a plan from complying with a QDRO just because the distribution would have been premature if it had been made to the participant. This provision would make spousal rights dependent on the quirk of whether the participant was covered by a profit-sharing or stock bonus plan (which can make distributions relatively freely) or by a PAYSOP, cash or deferred or pension plan (which are subject to premature withdrawal restrictions).

It is clearly in the interests of spouses and dependents as well as in the interest of employers that they be entitled freely to follow QDRO's without regard to the particular withdrawal restrictions imposed on plan participants. Accordingly, we urge that Section 2(c)(4)(A)(v) of S. 814 be revised by eliminating subparagraphs (B) and (C) and by extending the general rule in subparagraph (A) to cover all plans, including PAYSOPS.

(d) Penalty for Rehire

Section 2(A)(2) of the proposed technical corrections bill would impose a potentially severe penalty on individuals who go back to work for a former employer. This provision is totally inconsistent with the most basic objective of REA, which was to make it possible for former employees to return their employers and thereby preserve benefits that they had previously earned.

Under this provision, if an individual terminates employment before his or her entire benefit is vested and receives a lump sum distribution which the individual elects to have taxed under the ten year averaging method and that individual thereafter returns to work for the employer before incurring five break in service years and accrues more vesting credit, the employee has to pay a recapture tax equal to the tax benefit the employee received by claiming ten year averaging on the prior distribution.

Under current law, a somewhat analogous rule exists, but an individual must return to work within about one year in order for it to apply. See Temp. Treas. Reg. § 11.402(e)(4)(A)-1. The Internal Revenue Code itself has no "recapture" rule similar to the proposed five year rule.

The rules relating to taxation of participant distributions are among the most complex provisions which individuals ever have to deal with under the tax laws. The proposed change would add yet another new layer of complexity and could prove a severe impediment to rehiring former employees. For example, an individual might have received ninety-five percent of his or her account in connection with an earlier termination of employment and be subject to a very large recapture tax penalty if the individual returns to work within five years. It may be less expensive for the individual not to return to work than to pay the tax. Moreover, employees who do return to work may not have the cash to pay the tax.

The question then is, why is this provision sound and necessary? This provision essentially has its roots in an unreasonable IRS interpretation of the lump sum distribution requirements of Code Section 402(e). Those provisions require that an employee have received the "balance to his credit" under a plan to qualify for special tax treatment. When ERISA extended the time for forfeitures of unvested benefits to one year after termination of employment, the IRS should have interpreted "balance to the credit" to mean the vested balance. However, the IRS insisted on taking the unvested balance into account, unless it ultimately was forfeited.

Under the ERISA rules, the IRS position, although unreasonable, did not cause significant problems since unvested balances were forfeitable within a relatively short period of time after termination of employment. Under REA, however, forfeitures may not occur for a minimum of about five years and this makes the IRS position, which was always unreasonable, suddenly very burdensome. It is quite ironic that provisions which were designed to liberalize ERISA rules to permit people to return to work to save benefits would serve as a basis for imposing a penalty for returning to work.

For all of the foregoing reasons, we strongly urge that this penalty provision be deleted in its entirety. Ideally, this provision should be replaced by one which would eliminate any kind of recapture possibility by defining the term "balance to the credit" in Section 402(e) of the Internal Revenue Code to mean the "vested balance to the credit." If such a liberal rule is not possible, a reasonable compromise would be to apply recapture if the individual is rehired before the due date for filing his or her tax return for the year in which the distribution occurred.

III. Technical Corrections Which Are Not in the Bill But Which Should Be Made

Three necessary technical corrections have not been included in S. 814. The first is clarification of the language in the sections in ERISA and the Internal Revenue Code which were amended by REA to establish a new requirement that benefits cannot be "immediately distributable" without participant consent. The second is elimination of the maternity/paternity provisions in REA. The third is to permit domestic relations orders to be turned into QDRO's by means of stipulated modifications.

(a) The "Immediately Distributable" Requirement

REA included in ERISA and the Code a provision which makes it illegal for benefits to be "immediately distributable" without a participant's consent unless the benefits are de minimis in amount. REA did not modify the provisions which establish maximum time limits by which benefits must be paid. Accordingly, most employers interpret the "immediately distributable" language as simply precluding mandatory benefit commencement before a participant's attainment of normal retirement age or death or pursuant to a QDRO. Employers, however, are concerned that this provision might also be interpreted as forbidding plans to make all distributions in lump sums. Another possible reading of the provision is that it is merely intended to prohibit lump sum distributions which commence before the participant's normal retirement age, death or pursuant to a QDRO. Since this provision is ambiguous, it should be clarified. We recommend that the provision be clarified so that it only prohibits mandatory benefit commencement before normal retirement age or death except pursuant to a QDRO.

(b) Maternity/Paternity Leaves

By all accounts, the maternity/paternity leave provisions of REA were included in it by mistake. Apparently, there were two alternative approaches being considered for giving women greater flexibility to leave an employer and return to work without losing benefits. One of the alternatives was a extension of the break in service year rules to require a minimum absence of about five years. The other alternative was the maternity/paternity leave provisions. When the five year break rule was adopted (clearly the more liberal rule), the maternity/paternity leave provisions apparently were retained by accident. This leads to anomalous results. For example, if an individual gives birth to a child and leaves work to take care of the child, the individual can take about six years off before losing benefits. For any other absence, the individual can only have five years off. Besides being anomalous, the maternity/paternity leave provisions are just one additional unneeded and burdensome protective measure with which employers and employees must deal. It should be eliminated at this time.

(c) Stipulated Modifications to QDRO's

As currently written, the QDRO provisions of REA require that a court order comply with a laundry list of technical requirements. Because family law specialists are not expert in retirement benefit law, it will be very uncommon for domestic relations orders to comply with all of the new statutory requirements, at least if past practices are any indication of the future. Frequently, the deficiencies in an order can be easily rectified, such as by the simple expedient of clarifying which plan is required to pay the distribution. As the QDRO provisions currently exist, a plan could be disqualified for following a defective QDRO which is modified by mutual agreement of the parties to cure the deficiency. This means that prudent plan administrators will require that alternate payees go back to court to get court approval of needed modifications before following the orders. This is inconsistent with the spirit of REA and adds an additional burden on plan administrators and alternate payees alike. Accordingly, the QDRO provision should be modified to include a provisions which would permit defects in a QDRO to be rectified by agreement between the plan administrator and the alternate payee, at the option of the plan administrator. Participant consent should not be required unless the corrections to the order could in any way affect the participant's right to benefits. Such a change would make the QDRO provisions a great deal easier with which to live and help them achieve their purposes.

IV. Technical Corrections Which Should Be Modified

Section 2 of the proposed technical corrections bill would permit a surviving spouse to consent to a beneficiary designation after the participant's death without tax liability, but only if the participant died after enactment of REA but before it became effective. There is no reason why a spouse should not be permitted to consent to a beneficiary designation without tax consequences after the death of the participant in every pre-retirement death situation. This is particularly necessary in defined contribution plans since relatively few defined benefit plans provide pre-retirement death benefits other than surviving spouse benefits. In defined contribution plans, the almost universal rule is that, on a participant's death, his or her account vests and is paid to his or her designated beneficiary. By allowing post-death beneficiary consents, spouses will be protected in that they need not consent until the last possible minute, when their personal circumstances will be clearer. In fact, many employers specifically make spousal consent revocable just for this purpose. For all these reasons, the provision in the technical corrections bill which limits taxfree, post-death spousal consents to those made in a short window period before the effective date of REA should be broadened to apply to all beneficiary consents made in pre-retirement death cases, whether before or after the effective date of REA.

MAYER, BROWN & PLATT
2000 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006

CHICAGO
LONDON
NEW YORK
DENVER
HOUSTON

202-463-2000
TELEX 892603
CABLE LEMAYDC

June 7, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
U.S. Senate
Dirkesen Senate Office Bldg.
Washington, D. C. 20510

Re: Technical Corrections Act of 1985 (S. 814)/
Code Section 168(f)(10)

Dear Mr. Chairman:

This statement is submitted for the record of your June 5, hearing.

Summary of Recommendation

Technical Corrections Act section 109(b)(1) would make important and unanticipated substantive modifications to the Code section 168(f)(10) step-in-the-shoes depreciation rules. Therefore, a prospective effective date which gives taxpayers fair notice of the proposed changes is required.

Background

The Deficit Reduction Act of 1984 ("DEFRA") extended the ACRS recovery period for real property from 15 to 18 years. No change was made in the recovery period for 5-year property.

Current Code section 168(f)(10)(A) and (B)(iii) treats the transferee in a sale-leaseback transaction as the transferor for purposes of computing the ACRS deduction with respect to so much of the subject property's basis as does not exceed the transferor's adjusted basis.

Thus, under existing law, if a transferor of real property elected 15-year straight line depreciation, his transferee would step-into-the-transferor's-shoes, i.e., continue to use the straight line rate for 15-year real property over the remaining portion of the 15-year period with respect to so much of the property's basis as does not exceed the transferor's adjusted basis.

Nevertheless, the General Explanation of the Revenue Provisions of DEFRA prepared by the staff of the Joint Committee on Taxation (the "Blue Book") indicated at page 329 that "the Congress intended different results". More specifically, the Blue Book indicated that "the Congress generally intended that the new rules [i.e., 18 year depreciation] would be fully applicable to real property qualifying as recovery property in the hands of the transferee unless the transferor had made an election with respect to the property under section 168[(b)](3)", i.e., had elected straight line depreciation over 15, 35, or 45 years. The Blue Book also indicated that "a technical amendment will be recommended in this regard". However, its details were not disclosed.

It was generally understood that the Joint Committee staff intended to recommend a substantive amendment which would preclude sale-leasebacks designed to obtain faster depreciation, i.e., an anti-churning rule to preclude using 18-year depreciation of real property where a transferor had elected 35- or 45-year straight line depreciation. There was no Blue Book indication of any contemplated change in step-in-the-shoes depreciation for 5-year property.

In reliance on existing law and the Blue Book statements, a large sale-leaseback transaction involving primarily real property and some personalty was closed on April 5, 1985. The transferor had elected 15-year straight line depreciation under section 168(b)(3) as it applied before the enactment of DEFRA. It was, thus, understood that the transferee would, under current law, step-into-the-shoes of the transferor and continue to use 15-year straight line depreciation for the real property and 5-year accelerated depreciation for the 5-year property, the transferee, in both cases, assuming the transferor's ACRS schedule in mid-stream.

As a brief overview, the transaction involved two unrelated corporate owner-participants, their respective parents, an institutional lender, an owner-trustee, a corporate lessee, its parent, a corporate remainderman, and its parent. The documents reflecting the transaction are voluminous and considerable effort was expended negotiating and documenting the transaction in reliance on existing law.

In brief outline, the key dates regarding the transaction are:

(1) January 16, 1985 - lender issued its original commitment.

(2) January 31, 1985 -

(a) letter signed among owner-participant, lessee, and remainderman, subject to necessary approvals.

(b) approval granted by investment committee of owner-participant.

(c) approval granted by executive committee of lessee.

(3) March 6 and 7, 1985 - extensive negotiations concluded with agreement reached on all major definitive terms of documents.

(4) March 22, 1985 - lender's commitment finalized.

(5) April 5, 1985 - transactions closed.

Problem

Section 109(b)(1) of the Technical Corrections Act would amend Code section 168(f)(10)(A)(ii) to provide:

> if the transaction is described in clause (ii) or (iii) [i.e., is a sale-leaseback] of subparagraph (B) and the transferor made an election with respect to such property under subsection (b)(3) or (f)(2)(C), the transferee shall be treated as having made the same election (or its equivalent).

The amendment would apply to property placed in service by a transferee after March 28, 1985, the date the Technical Corrections Act was introduced. Act section 109(b)(3).

The description of the Act prepared by the staff of the Joint Committee is dated April 4, 1985, but it did not become generally available to the public until several days later. At page 27, it explained for the first time

> that the "(or its equivalent)" language of proposed Code section 168(f)(10)(A)(ii) is intended to require that "if the transferor was depreciating 15-year real property on a straight line basis, the transferee would be treated as having elected 18-year straight line depreciation";
>
> that "the transferee starts depreciating the property as would any other new owner of it"; and
>
> that this change would apply to both 15-year real property and 5-year property.

Clearly, no taxpayer or its advisor could have been expected on March 28, 1985, to anticipate these proposed substantive changes. Nor could anyone on that date fairly be expected to have a copy of the bill available; to be able to locate within its 225 pages the proposed amendment; or to understand its proposed application.

The proposed March 28, 1985, effective date (rather than the even more retroactive DEFRA effective date) is an implicit recognition that the proposed amendments are important substantive changes that could not be fairly anticipated. Full fairness demands at a minimum that the amendments become effective only after taxpayers and their advisors have a decent opportunity after introduction to become aware of the proposals and their intended application.

Proposed solution

Taxpayers and their advisors are entitled to a minimum of 30 days in which to become familiar with proposed changes in existing law. Accordingly, the effective date in Act section 109(b)(3) should be modified to apply to property placed in service by a transferee after April 28, 1985.

As possible alternatives, it has been suggested (1) that the proposed amendments should be made effective with respect to property placed in service after the date your Committee takes action or (2) specific transactions should be excepted from the general effective date.

Our principal concern, of course, is that the transaction described above not be made subject to the proposed new rules. Accordingly, either of the alternatives would be satisfactory. Nevertheless, either an April 28, 1985, effective date or the first alternative seem "cleaner" and fairer, i.e., either would protect all parties for a reasonable "notice" period, not just those who have the sophistication and resources to make their concerns known to your Committee.

* * *

I would welcome the opportunity to answer any question or to discuss this matter with you or your staff.

Respectfully submitted,

Jerry L. Oppenheimer

JLO/smk

MAYER, BROWN & PLATT
2000 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006

CHICAGO
LONDON
NEW YORK
DENVER
HOUSTON

202-463-2000
TELEX 892603
CABLE LEMAYDC

June 7, 1985

By Hand

The Honorable Bob Packwood
Chairman
Committee on Finance
U. S. Senate
Dirksen Senate Office Bldg.
Washington, D. C. 20510

Re: Technical Corrections Act of 1985 (S.814)/
Amendment to Code Section 1092

Dear Mr. Chairman:

This statement is submitted for the record of your June 5, 1985, hearing.

Summary of Recommendation

A technical correction to Code section 1092 is needed to clarify that debt obligations do not have a short term holding period merely because they include inseparable puts.

Background

Section 1092(b) gives the Treasury broad authority to issue regulations regarding gain or loss on positions which are a part of a straddle. The regulations are to apply the principles of section 1233(b) to the extent consistent with the purposes of section 1092. The section 1092(b) regulations are intended to prevent taxpayers from using straddles to convert short term into long term gain. Section 1233(b) is similarly designed to prevent converting short term into long term gain.

Under section 1233(b), the holding period of property which is "substantially identical" to other property sold short by the taxpayer does not commence until the short position is closed. The acquisition of an option to sell property at a fixed price, i.e., a put, is treated under section 1233(b) as a short sale by the option holder, and the exercise or failure to exercise a put closes the short sale.

Holding periods of properties not "substantially identical" are unaffected by section 1233(b). Consequently, section 1092(b) authorized Treasury to promulgate straddle holding period rules similar to, but broader than, the section 1233(b) rules by substituting "offsetting positions" for "substantially identical property". See S. Rep. No. 144, 97th Cong., 1st Sess. (1981) 149.

Taxable and tax exempt debt instruments commonly give holders rights at stated times to sell the obligations at par (or in the case of obligations issued at a discount, at the issue price plus accrued discount) to the issuer, i.e., in effect one or more puts.

These inseparable put features are not abusive. Because the puts cannot be transferred separately from the instruments, they do not create the possibility of converting short term into long term gain or ordinary income to capital gain or of deferring income from one year to the next. Appropriately, these instruments and put features are not subject to section 1233(b), because section 1233(c) contains an exception for "married puts", i.e., puts acquired on the same day as the property to be used in exercising the put is acquired, and which, if exercised, are exercised through the sale of such property.

Problem

Section 1092(b) makes no reference to 1233(c), and recently adopted temporary regulation § 1.1092(b)-2T(a)(1) provides that "the holding period of any position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds . . . an offsetting position with respect to that position".

If the debt and an inseparable put are viewed as offsetting positions under the regulation, the holding period of a debt obligation which contains an inseparable put may not begin until the put feature is terminated. Thus, the holding period of any holder of a debt obligation with an inseparable put would always be short term. This could not have been intended.

Proposed Solution

It should be clarified that the section 1092 holding period rules do not apply to a debt instrument merely because of the existence of an inseparable put feature. This may be done by adding the following to section 1092(c)(2):

> (D) INSEPARABLE PUTS. -- A provision in a debt instrument which provides that the holder may tender the instrument to the issuer for purchase does not constitute an offsetting position with respect to such debt instrument or to other debt instruments, when such provision is a right which cannot be disposed of or exercised by the holder of the debt instrument separately from a transfer of such debt instrument.

Alternatively, the following could be added to the end of section 1092(d)(2):

> A provision in a debt instrument which provides that the holder may tender the instrument to the issuer for purchase does not constitute a position if such provision is a right which cannot be disposed of or exercised by the holder of the debt instrument separately from a transfer of the debt instrument.

* * *

I would welcome the opportunity to answer any question or discuss this matter with you or your staff.

Respectfully submitted,

Jerry L. Oppenheimer

Jerry L. Oppenheimer

JLO/smk

MCCUTCHEN, DOYLE, BROWN & ENERSEN
COUNSELORS AT LAW
THREE EMBARCADERO CENTER
SAN FRANCISCO, CALIFORNIA 94111
(415) 393-2000

CABLES MACPAG
TELEX 34-0397

SAN JOSE OFFICE
ONE ALMADEN BOULEVARD, SUITE 600
SAN JOSE, CALIFORNIA 95113
(408) 947-8400

June 12, 1985

NETWORK COURIER SERVICE FAX

Ms. Betty Scott-Boom
Committee on Finance
219 Dirksen Building
Washington, D.C. 20510

Dear Ms. Scott-Boom:

The following comments are submitted for consideration by the Committee on Finance with respect to S. 814, the Technical Corrections Act of 1985. These comments suggest changes to Section 280G of the Internal Revenue Code dealing with excess parachute payments. Section 280G was enacted by the Tax Reform Act of 1984, Public Law 98-369.

Summary. - Section 280G dealing with excess parachute payments will affect many ordinary compensation arrangements and therefore will create unnecessary disputes. To avoid this, and thus aid the administration of the tax laws, section 280G needs technical changes.

"Reasonable compensation for services rendered" under section 280G should be clarified with respect to employment contracts, retirement plans, and stock options. Also, the mechanics of the statute should be changed so it is triggered only after first taking "reasonable compensation" out of the calculation.

A. Section 280G Affects Many Ordinary Compensation Arrangements

If an executive receives "reasonable compensation for services rendered" on a change in control, there is no tax issue under section 280G. This rule works in theory but does not work well in practice because section 280G affects many ordinary compensation arrangements. Commonly, a terminated executive will receive payments from: a qualified pension plan, a qualified 401(k) plan, previously earned and voluntarily deferred salary or bonus, and post-retirement medical and life insurance benefits. There is no question that these amounts are "reasonable compensation for services rendered." Nevertheless, often these amounts alone will trigger section 280G, because when paid on change in control they are parachute payments and often total more than 3 times the base. After the statute is triggered, if any other amount received is not reasonable compensation for services rendered, it is hit by nondeduction and an excise tax.

This puts an extraordinary premium on what is "reasonable compensation for services rendered," and an agent has a double incentive (nondeduction and an excise tax) to challenge "reasonable compensation." In this context for the statute to be workable, and to avoid unnecessary disputes, there must be clear guidance on what is excluded reasonable compensation.

B. Reasonable Compensation - Clarification Is Needed

(1) Payments After Contract is Terminated. - If a new hostile board fires all the top executives but also pays them what they would have earned over the remaining term of their contracts, there is serious question whether this is reasonable compensation "for services rendered." Technically, no services will be rendered after termination. But the Joint Committee Blue Book says that payment for a covenant not to compete is for services "rendered," and the Congress should clarify that the same rule applies to the payment in settlement of a contract of employment. Otherwise, payment of an executive's basic livelihood will be subject to excise tax.

(2) Retirement Plans. - The Blue Book recognizes as reasonable compensation payment under a supplemental retirement plan that compensates an executive for benefits lost on a move from a prior employer. But this is only part of the problem: an executive who is older and loses his job on a hostile takeover may not be able to obtain a comparable job or may not be able to obtain retirement credit at his new job for prior service. Therefore, an employer must be able to protect its executives' retirement income. This is particularly the case for older employees who most need retirement benefits and often have a difficult time obtaining new employment. The Congress should make clear, therefore, that reasonable compensation for services rendered

includes a supplemental retirement income that provides an employee what he would have received had he worked to normal retirement age and his employment not been prematurely terminated on a change in control.

(3) Payments Under Pre-Existing Retirement Plans. - The "one year rule" of 280G(b)(2)(C) adds a presumption that payment under any amendment to a contract made within one year of change in control is contingent on change in control. It should be made clear, however, that any normal increase in compensation that creates an increase in retirement benefits under a plan's formula does not trigger the one year rule. This would be similar to the rule stated in the Blue Book that normal salary increases do not take a contract out of the grandfather rule.

(4) Stock Options. - It is not clear whether stock options are valued at grant or at exercise. The Blue Book, however, states that the grant of stock options is a transfer of property to be valued at grant. The Congress should make it very clear that this rule governs. It may be quite difficult to establish "reasonable compensation for services rendered" for amounts received on exercise because the amount received often is based on market forces and not on the individual's service. An employee should not be deprived by an excise tax of the benefit of his stock option bargain because the market is favorable. (The Congress may wish to distinguish between options granted under an established program approved by shareholders well before any takeover and options that are granted in the course of takeover activity. The one year rule may accomplish this goal.)

C. Reasonable Compensation - The Mechanics Do Not Work Right

Section 280G as now written is triggered when parachute payments, including reasonable compensation, are more than 3 times the base. Thereafter, parachute payments are reduced by reasonable compensation to determine if there are "excess" parachutes. If there is even $1 of parachute that is not reasonable compensation, nondeductibility and the excise tax apply. While "theoretically pure," this leaves no leeway for reasonable differences about reasonable compensation. This will lead to substantial litigation over reasonable compensation from publicly held companies, something previously avoided under the tax laws.

For proper administration, the statute must leave some leeway because the basic concept--"reasonable compensation"--is one over which reasonable people often differ. An easy way to do this is to eliminate "reasonable compensation for services rendered" from the definition of parachute payments. The statute then would be triggered only if parachute payments in excess of reasonable compensation ("real" golden parachutes) were more than 3 times the base. This would give room for some disagreement over what is "reasonable" and would catch the people who are the real focus of the statute.

Respectfully submitted,

McCUTCHEN, DOYLE, BROWN & ENERSEN

By Robert A. Blum

Robert A. Blum

McDONALD, HOPKINS & HARDY CO., L.P.A.
ATTORNEYS AT LAW

1100 EAST OHIO BLDG.
CLEVELAND, OHIO 44114
(216) 621-[illegible]

COMMENTS ON CORRECTIONS OF RETIREMENT EQUITY ACT OF 1984

Our firm represents many pension and profit-sharing plans and does the estate planning for many persons who are participants in pension and profit-sharing plans.

We are concerned about what appear to be some of the unintended effects of the Retirement Equity Act of 1984. We set forth in this memorandum proposed provisions to be included in the Technical Corrections to the Retirement Equity Act of 1984 as published in the Congressional Record of April 18, 1985 (page E1583).

1. Proposed Amendment

There shall be added at the end of Section 417(a)(2) the following: "Such consent may be given at the time of the participant's election to waive or at any time thereafter, whether before or after the death of the participant."

Explanation

Section 417(a)(2) does not state when the consent of the spouse can effectively be given. The Senate Committee Report states "This consent is to be given in writing at the time of the participant's election, and the consent is to acknowledge the effect of the election." Section 417(e)(2) states "If - . . . the participant and the spouse of the participant (or where the participant has died, the surviving spouse) consent in writing to the distribution, the plan may immediately distribute the present value of such annuity." This obviously contemplates the possibility of a consent by the spouse even after the death of the participant. Whether the distribution under this clause can be any other than a lump-sum is not clear. There are many estate plans in effect involving trusts carefully designed to provide for the surviving spouse. There seems to be no good reason why the surviving spouse should be unable to consent to that kind of a provision even after the death of the participant. It is not clear from the law that this would be possible. There seems to be no good reason for limiting the time during which the spouse might consent, or the method of distribution to which the spouse might consent.

2. Proposed Amendment

There shall be added at the end of Section 417(a)(2) the following: "Such consent shall not be deemed a transfer by the participant's spouse under any provision of the Internal Revenue Code."

Explanation

The Retirement Equity Act of 1984 seems to have created a new property right. A question has been raised concerning the effect of the spouse's consent under Section 417(a)(2) with reference to that property right. Is it a transfer for gift tax purposes or estate tax purposes? Presumably, it was not contemplated that the passage of this law would raise gift tax or estate tax questions. It is suggested that the best way to avoid any problems in this area would be a provision such as set forth here.

3. Proposed Amendment

There shall be added at the end of Section 417(a)(2) the following: "To the extent that an agreement as defined in the next sentence permits a participant to designate a person other than his spouse as beneficiary of his interest in a qualified retirement plan, such participant may elect the waiver provided in Section 417(a)(1)(A) without the consent of his spouse as otherwise required by Section 417(a)(2)(A). 'Agreement' as used in the previous sentence means a binding agreement between the participant and his spouse entered before marriage or during the pendency of an action for legal separation or divorce."

Explanation

It has been suggested by commentators that this new law would supersede valid prenuptial contracts between husband and wife. The law is not clearly stated to get this result, and any such result is sure to create constitutional questions of impairment of contract. It would appear wise to avoid such disputes; and there appears to be no reason that Federal Pension Law should attempt to override valid contracts made in good faith either before marriage or during the pendency of an action for divorce in a situation in which death occurs before divorce is granted.

4. Proposed Amendment

There shall be added at the end of Section 401(a)(11) the following:

"(E) Definition - As used in this paragraph 'accrued benefit payable to such participant' shall not include any contribution of an employee to the plan except mandatory contributions made by the employee as defined in Section 411(c)(2)(C)."

Explanation

It is unclear whether the requirement of waiver and consent applies to the voluntary contributions made by a participant from his after-tax funds. Heretofore, the principal amounts of such voluntary contributions have been subject to withdrawal by the participant without tax consequences, and have not been generally considered a part of a true pension account. The status of the voluntary accounts for purposes of consent should be clarified one way or the other. It is suggested that they need not be subject to the consent to give the spouse adequate protection.

Respectfully submitted,

McDonald, Hopkins & Hardy Co., L.P.A.

By ____________________

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MERCER-Meidinger

TESTIMONY OF

GERALD L. USLANDER
PRINCIPAL

WILLIAM M. MERCER-MEIDINGER, INCORPORATED

BEFORE
THE COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES

MAY 16, 1985

My name is Gerald L. Uslander. I am an Attorney and a Principal of William M. Mercer-Meidinger, Incorporated. Mercer-Meidinger is the world's largest consulting firm in the field of employee benefits, compensation and communications. Mercer-Meidinger provides consulting advice to more than 10,000 clients in every category of business, industry, government and non-profit organizations. Our clients range in size from the smallest employers to the largest corporations in the world. Because of the broad based nature of our clients, I bring to you a wide range of needs for clarification.

I commend your quick response and your effort to provide needed clarifications to DEFRA and REA. However, H.R. 1800 and H.R. 2110 would make substantive and nontechnical changes to the laws in addition to merely technical clarifications. DEFRA and REA were two pieces of major legislation affecting employee benefits passed in the same year. You can imagine the reaction of employers to having to make wholesale changes to their plans to comply with DEFRA and then shortly thereafter REA, and both falling so soon after TEFRA. I believe it is essential that H.R. 1800 and H.R. 2110 confine themselves to purely technical clarifications so that employers will not be required to make additional substantive changes at this time.

I would hope that any substantive changes in the law would only be made after extensive deliberations by Congress and that any such changes will give employers a substantial amount of advance notice before they become effective.

With one exception, my remarks today will concentrate on the technical corrections to the Retirement Equity Act being proposed in H.R. 2110. I only have one observation concerning H.R. 1800.

DEFRA imposed funding limitations on funded welfare benefit funds in order to prevent what Congress deemed excessive deductions by employers making contributions into these funds. It is true that DEFRA, as written, has caused confusion in the area of insurance contracts as to what is or is not a fund. If the vehicle is determined not to be a fund, the funding restrictions will not apply.

Section 151(a)(8) of H.R. 1800 attempts to clarify the definition of welfare benefit fund. However, the clarification only adds to the confusion. It is difficult to determine exactly what kind of an arrangement, which would not be a fund, is being described in the new proposed provision. I have conferred with a number of professionals in my firm who deal exclusively in the area of welfare benefits, and they have been unable to recognize exactly what is being described. Our general feeling is that what the change is attempting to make clear is that a "truly experience rated" insurance contract will be considered a fund and anything else will not be considered a fund. I would hope that the language of the change can be tightened up to make this, or the actual intent, more apparent. I would also hope that the committee report will fully explain the significance of this provision.

I have a number of observations concerning H.R. 2110:

1. There is widespread disagreement, even among various Treasury Department spokesmen, regarding the definition of Earliest Retirement Age. IRC 417(f)(3) defines Earliest Retirement Age as the "earliest date on which, under the plan, the participant could elect to receive retirement benefits." IRC 417(c) says that if a participant dies before having attained the earliest retirement age, the surviving spouse will be entitled to a pre-retirement survivor annuity which need not begin earlier than the month in which the participant "would have attained the earliest retirement age under the plan."

   In the case of a vested participant or former participant who dies before satisfying the requirements for the early retirement age, when is the earliest time at which the surviving spouse can elect to receive the annuity? For instance, if a plan has an early retirement age of 55 with 15 years of service, and a normal retirement age of 65, and if a participant dies at the age of 50 with 10 years of service, may the spouse begin to receive the annuity when the participant would have reached age 55 with 15 years of service, had he lived, or only at the date the participant would have reached age 65, which is the latest date that commencement of the annuity can be postponed without spouse consent? In other words, is the intent of the law that it be assumed that the participant would have satisfied the service requirement had he continued to live?

   Many steel plans allow retirement with 30 years of service. The same question would apply if a participant in a steel plan died before being credited with 30 years of service. Would the participant's surviving spouse be entitled to the pre-retirement survivor annuity at the time the participant would have had 30 years of service or would the spouse have to wait until normal retirement age? As I said, various Treasury Department spokesmen have given different answers. The provision should be clarified one way or the other. My recommendation is that the law be made clear that service would have continued after death.

2. There are several issues relating to spouse consent that need clarification. IRC 401(a)(11)(B)(iii) states that a profit sharing or stock bonus plan does not have to comply with the qualified joint and survivor annuity and pre-retirement survivor annuity requirements if certain conditions are met. One of these conditions is that the plan provide that the participant's accrued benefit "is

payable in full, on the death of the participant, to the participant's surviving spouse..." or to another beneficiary only with spouse consent. It seems clear from the wording of this provision that if the conditions for nonapplicability of the joint and survivor annuity requirements are met, and the plan provides that the participant's benefit will be paid to the spouse, no spouse consent to that payment in a lump sum should be required.

In spite of this, a Treasury spokesman said that, unless the spouse consents, at least one-half of the participant's account balance has to be paid in the form of a life annuity. The only provision of the Internal Revenue Code that provides for spouse consent to a lump sum distribution is in IRC 417(e)(2). However, IRC 417 only applies to a plan which must meet the requirements of IRC 401(a)(11). In the case of a profit sharing plan which does not have to meet the requirements of IRC 401(a)(11), IRC 417(e)(2) does not apply and should not be made applicable.

This point should be clarified either in IRC 401(a)(11) or IRC 417. If it is intended that the distribution to the spouse should be subject to the general cashout rules in IRC 411(a)(11), that provision should be rewritten because it now only provides for consent of the participant and not the participant's spouse to a cashout over $3500.

Section 2(b)(4) of H.R. 2110 amends IRC 417 to provide that no portion of a participant's accrued benefit may be used as security for a loan without spouse consent. It is my understanding that Committee staff intends that this spouse consent provision should apply to all plans, whether or not they must comply with the joint and survivor annuity requirements of the law. Since the amendment requiring spouse consent to loans is in IRC 417, which section only applies to plans which must comply with the joint and survivor annuity requirements, I do not believe that the objective of applying the spouse consent requirement to all plans has been met.

I suggest that there be a clarification that the requirement does not apply to plans which need not comply with the joint and survivor annuity requirements. If your intention is that it does apply, the new spouse consent requirement should be placed in another section of the Internal Revenue Code.

Section 2(b)(6) of H.R. 2110 also amends IRC 417 to provide for informed consent, whereby the spouse, in consenting to the waiver of the joint and survivor annuity, must also consent to the beneficiary designated in the waiver and to each subsequent beneficiary change. While it is clear that the spouse must consent to beneficiary changes, it is not clear whether the spouse must consent to a change in the form of payment. For example, if the spouse consents to the children being named as the beneficiary of a form of payment, can the participant then change the form of payment and take a lump sum without naming a different beneficiary, and without spouse consent? This point should be clarified.

3. There are a number of issues relating to cashout of benefits which create problems. The threshold for determining whether there may be a unilateral cashout or whether there may be a cashout only with the consent of the participant (and his spouse where applicable) is a present value equal to $3500. The law is clear that the present value will be calculated using an interest rate not greater than the rate used by the Pension Benefit Guaranty Corporation for purposes of determining the present value of a lump sum distribution on plan termination. An open question is whether this same PBGC rate must be used to determine the amount of the benefit to be cashed out.

   The law should be clarified to state that the PBGC rate will be used to determine the threshold, but the rate stated in the plan for calculating a lump sum distribution will be used to determine the amount of the benefit. If it is permissible for the rate in the plan to be used for other purposes, I see no reason why it should not be used in this case.

   As an alternative, perhaps the PBGC rate could be used to determine the amount of the benefit if it is a cashout under $3500, while the plan rate could be used to determine the amount of the benefit if it is more than $3500. The rationale for this would be that the participant would have to consent to the cashout if it is more than $3500, so the participant can control the rate to be used.

   Another open question concerns the fact that there is apparently not a single PBGC rate. There are alternative rates, such as the PBGC immediate rate or the single PBGC rate structure. Various IRS spokesmen have given various answers as to whether the immediate rate or the entire rate structure is to be used. I have no recommendation as to which approach should be adopted, but recommend that one or the other be adopted in order to clarify the situation.

   The law should be clarified as to whether the cashout rules apply only to the employer funded accrued benefit, or also apply to employee contributions. I believe that the cashout rules do apply to employee contributions, and in determining whether the threshold has been met, both employer contributions and employee contributions are taken into consideration. However, there is disagreement on this point and clarifying guidance is needed. In addition, the guidance should state whether qualified deductible employee contributions are also to be considered.

A related issue is whether the cashout rules apply to the entire accrued benefit or only to the vested portion. In other words, must the vested accrued benefit be $3500 or more to have met the threshold or must only the entire accrued benefit, whether or not fully vested, be $3500 or more?

H.R. 2110 amends IRC 414(p) to prohibit the cashout of a benefit due a payee under a qualified domestic relations order, even if the payee/spouse consents, prior to the participant's termination of employment, if the amount of the payment due exceeds $3500. This provision seems to apply to any plan. It should not apply to defined contribution plans. The effect of this would be to require periodic payments from defined contribution plans and to prohibit lump sum distributions even if the payee consents. This is not consistent with the purposes of the qualified domestic relation order provisions, which are to protect the rights of the divorced spouse and to simplify the administration.

In addition to preventing a cashout even with spouse consent, including the restriction in defined contribution plans could cause other adminstrative problems. For instance, if the plan allows participants to direct investments among various investment funds, wouldn't this right also have to be given to a QDRO payee whose benefit could not be distributed because it is over $3500? It seems that the answer could be in the affirmative and this would unduly complicate plan administration.

4. IRC 401(a)(11)(B)(iii)(I) says that, in order to avoid compliance with the joint and survivor annuity requirements, a defined contribution plan that provides for a death benefit to someone other than the spouse, must provide that the spouse consents to the non-spouse beneficiary in the manner required under IRC 417(a)(2)(A). This latter section only covers the fact that the consent must be in writing and witnessed. It does not deal with the requirement to give notice nor does it deal with the time frames of giving notice and making the election. I suggest that IRC 401(a)(11) be clarified so that the reference is to those sections of IRC 417 that cover the notice requirement and the timing requirements, or else special notice and timing requirements be provided.

5. I suggest that the law be clarified as to whether a spouse's waiver of the joint and survivor annuity constitutes a gift that is taxable for gift tax purposes. This problem arises

> because H.R. 1800 repeals IRC 2517. IRC 2517 provides that the exercise or non-exercise of an election or option under a qualified plan is not considered a transfer for gift tax purposes. If this section is repealed, the question arises whether spouse consent would be a taxable transfer.

There are many other areas that could be discussed as needing clarification in both H.R. 1800 and H.R. 2110. However, it would not be possible to include all of them in my presentation.

I urge you to impress upon the Treasury Department the urgency of moving promptly to issue formal guidance on the various changes made by DEFRA and REA. Many questions have been asked of Treasury by practitioners, so they are well aware of areas that need clarification and guidance. With so many recent laws having been passed that affect benefits in varying ways, employers must have immediate guidance on how to proceed with the administration of their various benefit programs.,

I want to thank you for your indulgence and for giving me the opportunity to assist you in discussing needed clarifications to DEFRA and REA. Both I and my firm are at your and your staffs' total disposal in proceding with your work. We stand ready to assist you in any way we can and would welcome your calling upon us.

National Coordinating Committee for Multiemployer Plans

SUITE 603 • 815 SIXTEENTH STREET, N.W., WASHINGTON, D.C. 20006 • (202) 347-1461

COMMENTS OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS ON S. 814, THE TECHNICAL CORRECTIONS ACT OF 1985, AND ON TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984

COMMENTS ON S. 814, THE TECHNICAL CORRECTIONS ACT OF 1985, AND ON TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984

The National Coordinating Committee for Multiemployer Plans ("NCCMP") is pleased to offer its comments on S. 814, the Technical Corrections Act of 1985, and on technical corrections to the Retirement Equity Act of 1984.

The NCCMP is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 140 pension and welfare plans, or their sponsors, through which, in the aggregate, the interests of approximately three million persons are represented. On behalf of its affiliated multiemployer plans and their participants and beneficiaries, the NCCMP is entirely engaged in monitoring the development -- legislative, administrative, and judicial -- of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

We suggest reconsideration of several aspects of and technical improvements in the Technical Corrections Act of 1985 and certain provisions of the Retirement Equity Act of 1984, as they would apply to multiemployer plans.

A. The Technical Corrections Act of 1985 ("Bill")

1. Permissible Welfare Plan Reserves

a. Reserve Limits Applicable to Collectively Bargained Welfare Plans

Section 419A[1] as added by the Deficit Reduction Act of 1984 ("DRA"), provides tax deductible reserve limits for welfare plans. Section 419A(f)(5) directs the Secretary of Treasury to provide special, higher limits for collectively bargained plans no later than July 1, 1985.

The Conference Report states:

> "Certain collectively bargained plans. -- By July 1, 1985, the Treasury Department is to publish final regulations establishing special reserve limit principles with respect to welfare benefit funds maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence of good faith bargaining over the benefits provided by the plan between the employee representatives and the employer (or employers).
>
> In establishing these limits, the Treasury is to presume that reserves in such plans are not excessive because of the arm's length negotiations between adversary parties inherent in the collective bargaining process. Because contributions under such plans are often made on the basis of a defined contribution fixed over a multiyear period on the basis of economic assumptions which prove to be incorrect and because such contributions may be the only source of benefits to be provided during layoffs, strikes, lockouts, and economic recession, these

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[1] Unless otherwise stated, all references herein are to the Internal Revenue Code of 1954, as amended.

> special limits are to allow substantial flexibility in determining the application of these provisions with respect to such plans." H.R. Rep. No. 861, 98th Cong., 2d Sess. 1158 (1984).

In this report, Congress clearly stated two things about collectively bargained plans. First, the nature of such plans, and of the collective bargaining process, generally precludes the abuses of principal concern. Second, the practical requirements of such plans (e.g., the need to set contributions at some fixed rate based on hours of work or units of production) and the plans' basic economics,[2] mandate special reserve principles.

Recognizing the basic facts set forth above, Congress also gave specific instruction as to how the situation should be handled: the reserves of such plans are to be presumed reasonable. In other words, the reserve limitations of this newly-enacted provision are not generally to apply in the case of collectively bargained plans.

Perhaps it is possible for the Treasury to fashion regulations accurately reflecting the Congressional intent discussed above. However, after a review of many specific situations, and a good bit of effort, we have been unable to devise any formula or other standardized approach that would cover the vast array of fact patterns actually presented.

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[2] Employer contributions do not rise to meet plan needs. Instead, they generally fall in times of aggravated participant need, e.g., recession, strike or layoff.

Perhaps the regulations could merely restate the generalized intent reflected in the report, providing that the reserves of collectively bargained plans will be deemed within the applicable reserve limitations, unless the IRS establishes their unreasonableness in particular situations. Such a regulation would be entirely appropriate if the problem is actually to be addressed by regulation. However, the Congressionally imposed deadline is upon us, and guidance is desperately needed now.

Given the foregoing, we submit that Congressional intent would best be served by explicit statutory language setting forth a general rule on the reasonableness of reserves in collectively bargained plans. Such an approach makes particularly good sense in light of the nearness of the July 1, 1985 deadline set by Congress for final regulations on this subject. Proposed regulations have not yet been issued, and timely issuance of carefully developed regulations seems unlikely given the current agenda of appropriate Treasury and IRS personnel.

Consequently, we suggest that Code section 419A(f)(5) be amended in its entirety to read as follows:

> "(5) Higher Limit in Case of Collectively Bargained Plans --
>
> (A) Notwithstanding any other provisions of this section, for purposes of sections 419 and 512, the limit determined under this section for a qualified asset account established by a welfare benefit fund maintained pursuant to

> one or more agreements that the Secretary of Labor finds to be collective bargaining agreements between employee representatives and one or more employers shall be no less than the amount credited to that account, if --
>
> (i) there is evidence of good faith bargaining over funding for the benefits provided through the fund and
>
> (ii) the Secretary does not find that the fund's reserves are unreasonable, taking into account past experience and reasonable expectations. For this purpose, an amount in a reserve attributable to employer contributions shall be deemed to be reasonable if the level of contributions required was reasonably expected to be necessary to maintain the plan of which the fund is a part, under all of the circumstances existing and anticipated at the time the collective bargaining agreement setting the contribution obligation was agreed to.
>
> (B) For purposes of this paragraph, the term "amount credited to that account" includes assets to provide for the future payment of any welfare benefit, within the meaning of section 419(e)(2), in addition to the benefits listed in subsection (a) of this section."

The problems described above are particularly acute with respect to multiemployer plans. Such plans are required by the Taft-Hartley Act to function as jointly administered trusts. In these circumstances benefits cannot be provided directly from the general assets of employers. "Welfare benefit funds" must be utilized if benefits are to be provided at all.

Further, once an employer makes a contribution to a multiemployer plan, the money is gone forever. Also individual employers, as such, typically have little or no direct role in the plan trustees' decisions about what benefits to provide. Thus, unlike the situation that may exist in some single-employer plans, there is neither opportunity nor motive for "packing" with excess funds in order to accelerate deductions.

b. Additional Welfare Plan Reserve Limit Issues

Additional reserve limit issues are addressed below. We note, however, that these issues will become moot if the amendment suggested above becomes law.

i. Reserve Limit Transition Rules

Section 151(a)(7) of the Bill would make the reserve limit transition rules of section 419A(f)(7) available only to funds that had reserves "as of July 18, 1984." This is clearly meant to deny transition relief to employers who, for tax purposes, made large welfare plan contributions between enactment of the DRA and the end of 1984.

However, the new rule, as presently structured, would create unnecessary administrative burdens. Plans do not keep daily records of the status of their reserves. Thus, most plan trustees will not know if the plan had reserves as of July 18, 1984. They would be able to determine this, if at all, only through retroactive reconstruction of the plan's financial status as of that date.

We suggest that the transition rules be made available, instead, to plans that had reserves as of both the beginning and the end of the plan year that includes July 18, 1984.

This would adequately test plans on the basis of information they ordinarily have available.

In addition, for collectively bargained plans, the transition rules should apply if:

> "(A) The plan had reserves as of the end of the plan year that includes July 18, 1984, and
>
> "(B) Either:
>
> > "(i) no increase in the rate of contributions under the collective-bargaining agreement was negotiated between July 18, 1984, and the end of the plan year that included July 18, 1984; or
> >
> > "(ii) If a post-July 18, 1984, contribution rate increase was negotiated, such increase did not provide for a decrease after the end of the plan year that included July 18, 1984."

This would make the transition rules unavailable to plans that increased contributions until the end of 1984 to inflate the 1984 reserve for tax purposes. However, the rules would remain available in bona fide situations where deficits existed at the beginning of the 1984 plan year but, because of benefit cuts or legitimate contribution rate increases, there were surpluses by the end of that year.

A similar problem arises under section 151(a)(10)(C)(iii) of the Bill. That section would amend Code section 512(a)(3)(E)(iii)(II) to impose income tax on the earnings of post-retirement medical or life insurance welfare fund reserves in excess of the amount the fund had accumulated for such purposes as of July 18, 1984. As stated, it would be difficult, if not impossible, for plans to determine the reserves that existed on such a specific date. Instead, the test should be the existing level of reserves for such purposes as of the end of the plan year that includes July 18, 1984. Safeguards similar to those suggested above with respect to section 419A could be provided to prevent abuse.

ii. Treatment of Certain Insurance Contracts

Section 151(a)(8) of the Bill would exclude certain types of insurance contracts from the definition of a "welfare benefit fund." The exclusion would apply only if "the amount of any experience-rated refund or policy dividend payable to an employer with respect to a policy year is treated by the employer as received or accrued in the taxable year in which the policy year ends." This limitation is clearly intended to apply the credit income to reduce the employer's deduction for the initial premium. However, this rationale does not apply in the context of tax-exempt trusts. Accordingly, the legislative history should state that this limitation applies only if the experience credit is paid directly to an employer, and is not relevant if the contract holder that receives the credit is a tax-exempt trust.

2. Other Multiemployer Plan Issues

There are a number of other issues which are of importance to multiemployer plans, regardless of the disposition of the collectively bargained reserve limit issue.

a. Collective Bargaining Exceptions to Nondiscrimination Requirements of Sections 419A(e)(1) and 4976(b)(1)

Section 419A(e)(1) currently provides that no reserve may be taken into account under section 419A(c)(2) for post-retirement medical benefits or life insurance benefits unless the plan meets the nondiscrimination requirements of section 505(b)(1). Section 4976 imposes an excise tax on employers maintaining funds that provide "disqualified benefits." Under section 4976(b)(1), "disqualified benefits" include post-retirement medical or life insurance benefits, unless the plan meets the nondiscrimination requirements of section 505(b)(1) with respect to such benefits.

Sections 151(a)(3) and 151(a)(11) of the Bill would apply these rules to plans, such as collectively bargained plans, that are not otherwise subject to section 505. There would be an exception for benefits provided by a plan maintained under a collective bargaining agreement, if the post-retirement medical and life insurance benefits were the subject of good-faith bargaining.

Post-retirement welfare benefits, as such, are not necessarily the subject of direct bargaining in the multiemployer context. The bargaining parties often denominate separate contributions for pension and for welfare benefits. They ordinarily do not specify the actual benefits to be provided or the portion of the welfare benefit contributions that will be used to provide any particular type of benefit. Instead, these decisions are left to the plan trustees.

Since the intent of the change seems to be to continue the current law standard exception for collectively bargained plans, an additional exemption should be added with respect to both sections 419A(e)(1), and 4976(b)(1) for "benefits provided in the manner described in paragraphs (5) et seq. of 29 U.S.C. section 186(c)" -- i.e., collectively bargained and provided through a jointly managed trust in accordance with Taft-Hartley.

b. Effective Date of Section 512 Unrelated Business Taxable Income ("UBTI") and Section 4976 Excise Tax Changes

Under section 511(e)(2) of the Deficit Reduction Act of 1984 ("DRA"), the new UBTI provisions of section 512, and excise tax provisions of section 4976 will not apply to collectively bargained plans until the first day of the plan year starting after expiration of the longest-running labor contract in effect on July 1, 1985. Section 151(a)(12) of the Bill would add new paragraphs (6) and (7) to the end of section 511(e) as follows:

> "(6) Amendments Related to Tax on Unrelated Business Income -- The amendments made by subsection (b) [UBTI provisions] shall apply with respect to taxable years ending after December 31, 1985. . . .
>
> "(7) Amendments Related to Excise Taxes on Certain Welfare Benfit Plans. -- The amendments made by subsection (c) [excise taxes on disqualified benefits] shall apply to benefits provided after December 31, 1985."

The Bill should make clear that these new paragraphs are not intended to override the collective bargaining effective date provided in paragraph (2) of section 511(e) of the DRA. It would be difficult, if not impossible, for collectively bargained plans to comply with a January 1, 1986 effective date. Treasury will not announce the special reserve limits applicable to such plans until July 1, 1985, at the earliest. Further, there is no practical opportunity to readjust contribution rates until the expiration of the currently effective collective bargaining agreement. Finally, until passage of the Technical Corrections Bill, the extent, if any, to which a plan's benefit structure will have to be amended will remain uncertain. See section 1., supra.

c. Aggregation of Plans

Section 419A provides limits on the amount of disability and SUB or severance pay benefits and life insurance benefits that can be taken into account in determining permissible plan reserves. Further, it treats amounts allocable to individual accounts of key employees to pay post-retirement medical benefits as annual additions under section 415(c).

Section 151(a)(6) of the Bill would provide that, for purposes of these provisions, all welfare benefits of an employer must be treated as a single fund. For all other purposes of Section 419A, an employer would be permitted to elect to treat two or more welfare benefit funds he maintains as one fund.

Multiemployer welfare plans have no way of knowing whether contributing employers have other welfare plans. They have no control over or knowledge of contributions to or benefits under other plans of contributing employers. Thus, requiring multiemployer plans to aggregate single employer benefits for this purpose would be unfair and unworkable.

Further, higher reserve limits are to be prescribed for collectively bargained plans, including multiemployer plans. Thus, the limits on the amount of disability and SUB or severance pay benefits and life insurance benefits should not apply to such plans. With respect to the section 415(c) limits, if benefits under an aggregation of plans exceed such limits, Treasury regulations provide that benefits under the single employer, rather than the multiemployer, plan will be reduced. See Treas. Reg. §§ 1.415-8(e), 1.415-9(a)(3).

Accordingly, no purpose would be served by subjecting multiemployer plans to the required aggregation rules. Such plans should therefore be exempted.[3]

The Bill could nevertheless require a single employer plan to be aggregated with a multiemployer plan to the extent of that portion of the multiemployer plan that is allocable to the employer's employees. If the aggregated plans exceed the limits, however, only the single employer plan should be affected. For this purpose, the Treasury should be directed to promulgate simple, workable rules for allocating a share of the multiemployer plan's assets and liabilities to each contributing employer, without the burden and expense of tracing their actual source.

d. Gift Tax Changes

Section 152(e) of the Bill would repeal section 2517, which creates a gift tax exemption for an employee's designation of a beneficiary under a qualified pension or profit-sharing plan. The statute or legislative history should clarify whether a contingent or revocable designation of a plan beneficiary would be subject to tax. It should also clarify whether a spouse that consents, in accordance with the Retirement Equity Act of 1984, to waive his or her right to a death benefit would be subject to gift tax liability. Income tax treatment of amounts already considered part of a taxable gift or estate should also be clarified.

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[3] We note that aggregation of plans is also required for purposes of the UBTI rules added by the DRA. § 512(a)(3)(E)(iii)(III). Our comments apply equally in this context. However, the Secretary of Treasury is empowered to provide exceptions by regulations. We hope and expect that such regulations will provide the necessary exemption.

e. Top-Heavy Plan Provisions

Section 240 of the Tax Equity and Fiscal Responsibility Act of 1982 added a new section 416 which sets forth special rules for top-heavy plans. In general, a plan is considered top-heavy if the present value of the cumulative accrued benefits or aggregate account balances for certain highly paid officers and owners ("key employees") of the employer exceeds sixty percent of the present value of the cumulative accrued benefits or aggregate account balances of all employees under the plan. Code § 416(g). We note that section 152(d) of the technical corrections bill would make certain changes in the top-heavy provisions of the law.

The facts are that a multiemployer plan cannot be top-heavy, and that the sanctions applicable to top-heavy plans have no practical relevance in the multiemployer plan context.

The vast majority of multiemployer plan participants are bargaining unit employees who are generally not officers or owners of an employer and therefore not key employees. Further, most multiemployer plans provide non-integrated flat-dollar benefits that are unrelated to compensation. Thus, larger dollar benefit amounts are ordinarily based on longer terms of covered service rather than the higher pay that typically accompanies company ownership or officer status. The few key employees that might be covered by multiemployer plans would therefore have no advantage over non-key employees with respect to benefit accrual. It would therefore be virtually impossible for multiemployer plans to satisfy the definitional top-heaviness test of providing in excess of sixty percent of its benefits to key employees. For this reason, it would be unreasonable to subject multiemployer plans to the administrative compliance burdens of the top-heavy provisions.

Collectively bargained plans, including multiemployer plans, are already expressly exempted from the major substantive top-heavy requirements, i.e., the section 416(b), (c), and (d) requirements relating to faster vesting, minimum benefits or contributions, and a ceiling on the amount of compensation that may be used to compute benefits. Code § 416(i)(4). However, multiemployer plans are not expressly exempted from the section 416(h)(1) reduction in the section 415(e) dollar limitation on combined contributions to and benefits under defined contribution and defined benefit plans maintained by the same employer.

Such plans are further burdened by the section 401(a)(10)(B) requirement that all plans adopt boilerplate language to take effect if they become top-heavy. Under Treasury regulations, a plan is relieved of this requirement if it covers only employees included in a bargaining-unit and employees of employee representatives. This relief is inadequate and impractical, however, because a multiemployer plan may cover a small number of other employees. For example, union members who have become self-employed may, in some plans, maintain continuity of coverage. A few plans allow "special class" participation through which a company's salaried employees are covered as long as its union-represented employees participate. Further, the Treasury regulations do not make clear whether the exception would apply to plans that cover employees of the plan itself.

It would be unreasonable to subject multiemployer plans to these burdensome provisions, since no meaningful protection to multiemployer plan participants would be provided and no perceived abuses corrected. We therefore seek a technical correction, which would make clear that multiemployer plans are exempted from the top-heavy requirements, including the burdensome requirement to adopt boilerplate, top-heavy provisions that will almost certainly never become effective. The Secretary could be empowered to promulgate regulations limiting this exemption if necessary to prevent abuses.

The technical correction should also make clear that, for purposes of determining the top-heavy status of an employer's single employer plans, employers are to aggregate their share of the accrued liabilities of any multiemployer plan to which they contribute as though it were a separate plan. If this aggregation group is top-heavy, only the single employer, and not the multiemployer, plan would be considered top-heavy.

Employers should also be permitted to aggregate their single employer plans with their allocable share of a multiemployer plan's benefits, in testing for top-heaviness in their single employer plans. Such aggregation should be available regardless of whether benefits under the multiemployer plan are "comparable" to benefits under the single employer plans. The Secretary of Treasury should be directed to prescribe a simple, workable formula for determining each employer's "share" of multiemployer plan benefits for this purpose, without actually tracing contributions and benefits.

f. Definition of "Welfare Benefit"

Section 419(e)(2) should be amended to make clear that the term "welfare benefit" includes a post-retirement cost-of-living adjustment benefit which, pursuant to ERISA section 3(2)(B), is treated as a welfare benefit under Department of Labor regulations. This would explicitly subject such benefits to the amendments made by the DRA in sections 419, 419A, and 512.

B. Technical Corrections to the Retirement Equity Act of 1984 ("REA")*

1. Spousal Consent to Beneficiary Designation

REA requires written spousal consent to a waiver of the spouse's right to death benefits. It does not require the spouse to formally consent to the employee's election of an alternative payment form, or choice of another beneficiary.

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* References are to the House Bill, H.R. 2110 ("Bill"). We understand that there is as yet no similar Senate bill.

Once the spouse relinquishes his or her right to a death benefit, the employee is free to do whatever he or she wants with it.

Section 2(b)(6) of the Bill would amend section 417(a)(2) to give the spouse greater power to determine the disposition of such benefits. The waiver would be effective only if:

> "(A)(i) The spouse of the participant consents in writing to such election, (ii) such election designates a beneficiary which may not be changed without spousal consent (or the consent of the spouse permits designations of beneficiaries by the participant without any requirement of further consent by the spouse), and (iii) the spouse's consent acknowledges the effect of such election and is witnessed by a plan representative or a notary public, ..."

The change would apply to benefit elections made after the Bill's date of enactment.

In our view, the prevention of the occasional abuses at which this change is apparently aimed would not justify the administrative burdens that would be imposed on plans. Plans would be required to adopt yet another round of plan amendments. They would have to reprint appropriate forms, revise summary plan descriptions, mail additional explanations to employees etc. (At a minimum, these facts require a delayed effective date in the proposed change.)

There may be times when an employee designates a beneficiary his or her spouse did not contemplate and would not have approved. However, where the spouse has voluntarily waived his or her right to such benefit, the spouse's financial security will ordinarily not be enhanced through an ability to control the designation of the alternative beneficiary, if the employee can still choose a payout form that cuts out the spouse, e.g., lump sum, etc.

There are also technical problems with the proposed change. It would apparently require a spouse's waiver of his or her death benefit to be accompanied by the designation of another beneficiary. In most cases, however, a waiver of a qualified joint and survivor annuity at retirement will result in higher monthly annuity payments during the employee's lifetime, with no death benefit payable after the employee's death. And pre-retirement death benefits may be waived entirely, to avoid the charge for it that some plans are imposing. At a minimum, the Bill should accommodate these practices.

Further, qualified plans often provide death benefits in addition to, rather than instead of, the qualified spousal benefit. For example, multiemployer defined contribution plans are required to guarantee a spouse a pre-retirement death benefit based on only half of the employee's account. It would be useful for the legislative history to make clear that any waiver requirements apply only to the qualified joint and survivor and preretirement survivor benefits.

Involving the spouse in the beneficiary designation process could also create gift-tax problems for the spouse, if the proposal, in the Technical Corrections Act of 1985, to repeal Section 2517 is passed. If these provisions of the two technical corrections bills are enacted, the gift tax treatment of the spouse should be clarified.

2. Duplicate Death Benefits

Section 2(f) of the Bill would amend the joint and survivor transition rules in section 303(c) of REA to protect plans from having to pay duplicate death benefits as a result of the immediate effective date of REA's pre-retirement spousal death benefit rules, as follows:

> "(4) ELIMINATION OF DOUBLE DEATH BENEFITS. -- (A) IN GENERAL. -- In the case of a participant described in paragraph (2), the amount of any death benefit (other than a qualified preretirement survivor annuity) payable to any beneficiary shall be reduced by the amount payable to the surviving spouse of such participant by reason of paragraph (2).
>
> "(B) SPOUSE MAY WAIVE PROVISIONS OF PARAGRAPH (2). -- In the case of any participant described in paragraph (2), the surviving spouse of such participant may waive the provisions of paragraph (2). Such waiver shall be made on or before the close of the first plan year to which the amendments made by this Act apply. Such a waiver shall not be treated as a transfer of property for purposes of chapter 12 of the Internal Revenue Code of 1954 and shall not be treated as an assignment or alienation for purposes of section 401(a)(13) of the Internal Revenue Code of 1954 or section 206(d) of the Employee Retirement Income Security Act of 1974."

A few technical modifications are required with respect to this proposed change. It would apparently require an offset of the spousal benefit in all cases. However, plans often pay both a pre-existing death benefit and the REA benefit (e.g., in a money purchase plan where the REA benefit is only half of the account, or in cases where there is a separate children's benefit). Further, where the spouse is already the designated beneficiary for the pre-existing death benefit, the plan may offer him or her the choice between that and the REA benefit.

Accordingly, we suggest that the word "shall" in the proposed amendment be changed to "may." This would avoid requiring plans to reduce or eliminate benefits they intend to provide in addition to the REA benefit.

In addition, the proposed change would give a spouse the right to waive his or her benefit in favor of another beneficiary. However, such waiver would have to be exercised "on or before the close of the first plan year to which the amendments made by [REA] apply." The amendments made by REA apply first in the plan year that includes August 23, 1984. For most plans, this is the 1984 calendar year. Thus, the waiver opportunity will have elapsed before the Bill passes. We suggest extending this waiver opportunity to the end of the plan year in which REA is generally effective, i.e., the first plan year beginning after December 31, 1984 (REA section 302(a)) or, for a collectively bargained plan, the first plan year beginning on or after the earlier of: (1) the expiration of the last collective bargaining agreement relating to the plan; or (2) January 1, 1987 (REA section 302(b)). This is appropriate since the waiver right will only be necessary if the participant died in the period between enactment of REA and its general effective date.

The proposed language also protects waiving spouses from gift taxes and from the anti-alienation provisions of ERISA and the Internal Revenue Code. However, it leaves open the possibility that a spouse waiving his or her REA rights in favor of a designated beneficiary might be subject to income tax on the money as an assignment of income. The statutory language or legislative history should make clear that this is not the case.

The legislative history should also note that a settlement of a disputed claim to benefits is not a waiver and would not entail any adverse tax consequences that might otherwise be associated with a waiver.

3. Qualified Domestic Relations Orders ("QDROs")

a. Limit on QDRO Pay-Outs

REA allows an ex-spouse to receive benefits, under a QDRO, even if the employee is still working. It enacted a special rule protecting the qualified status of pension and 401(k) plans that pay benefits, under these special circumstances, before the participant terminates employment.

Section 2(c)(4)(A)(v) of the Bill would amend Code section 414(p). It would apparently permit a qualified pension or 401(k) plan to make payments to an ex-spouse while the employee is still working only if the present value of the payment is no more than $3,500.

We can see no justification for subjecting ex-spouses to such hardship with respect to benefits a court has ordered paid (and which REA may otherwise require). There is no reason why an individual entitled to a reasonable pension from his or her ex-spouse's plan should be forced to wait until that ex-spouse terminates employment. Indeed, in many cases, these benefits will be indispensable to the spouse's continued adequate support.

It is also unclear what benefits would be counted in determining whether the $3,500 limit is satisfied. The proposed language could be construed to count all of the payments that the ex-spouse is expected to receive before the employee terminates employment. Alternatively, it could be construed to count the total payments to which the ex-spouse is entitled.

We note that some plans have already started paying ex-spouses under QDROs without regard to the $3,500 limit. Thus, additional problems will be created because the proposed effective date of the change is January 1, 1985, the effective date of REA's QDRO provisions.

b. Service of QDROs

The Bill should also include a provision stating that a QDRO (or a non-qualified order) cannot affect any actions taken by a plan before a copy of it is delivered to the plan. For example, a plan that has not received a copy of a QDRO should be permitted to rely on a spousal sign-off, even if the QDRO gives the prior spouse a right to death benefits. It is obviously unfair and unworkable to require a plan to comply with a QDRO it has not received.

4. Spousal Consent To Use Plan Assets as Security for Loans

Section 2(b)(4) of the Bill would require spousal consent to the use of a participant's accrued benefit as security for a loan. This requirement would be effective for loans made after April 18, 1985.

April 18, 1985 has already passed, and plans have since been making loans without obtaining such spousal consent. Further, after REA and the DRA, plan managers have a great many other amendments to adopt, forms to revise, and other demands on their time. Accordingly, plans should be given a reasonable period prior to effectiveness of this requirement to enable them to make necessary preparations. We suggest January 1, 1986 as a reasonable effective date.

NATIONAL HOUSING LAW PROJECT
1950 ADDISON STREET
BERKELEY, CALIFORNIA 94704
(415) 548-9400

David M. Madway
Director
Richard E. Blumberg
Associate Director
Gideon Anders
Catherine M. Bishop
David B. Bryson
James R. Grow
Daniel D. Pearlman
Michael G. Smith
Frances E. Werner
Of Counsel:
Arnold C. Sternberg
Admitted only in D.C.
Property Management Specialist:
Margaret Weitkamp
Non-attorney

Washington D.C. Office
Suite 800
1016 - 16th Street, NW
Washington, D.C. 20036
(202) 659-0050

Gordon Cavanaugh
Admitted only in Pa
Lee P. Reno
Admitted only in D.C.
Florence Wagman Roisman
Admitted only in D.C. and N.Y.

June 7, 1985

Ms. Betty Scott-Boom
Tax Counsel
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: §102(a)(2)
Technical Corrections Act of 1985
S 814

Dear Ms. Scott-Boom:

This testimony is submitted for the record by the National Housing Law Project on the behalf of the following tax-exempt nonprofit organizations, which are actively involved in the development and preservation of low-income housing:

Jubilee West, Oakland, California
Madison Mutual Housing Association, Madison, Wisconsin
Orange County Community Housing Corporation, Santa Ana, California
St. Vincent De Paul Society of San Francisco, California
Womens' Development Corporation, Providence, Rhode Island.

Since 1968, the National Housing Law Project has been a resource center on housing matters for attorneys and others who represent poor people throughout the country. As a resource on housing matters, we have been intimately involved in both the implementation and enforcement of existing housing policies and the development of new programs and policies on both the state and federal levels. Our activities include providing assistance to Legal Services attorneys throughout the country on housing problems their clients regularly encounter, as well as seeking to strengthen the clients' rights to decent housing in Congress, at HUD and the Farmers Home Administration, with state and local governments, and in the courts. From this experience of over 17 years, we have gained an extensive body of knowledge regarding the housing needs of poor people and the actual workings of the federal programs.

Since 1981, we have developed expertise as to the federal tax aspects of low-income housing by advising and representing nonprofit housing developers who have wished to use investor syndication capital to assist them in building or maintaining low-income housing. From that background we offer the following suggestions to your committee.

Section 102(a)(2) of the Technical Corrections Act of 1985 would severely restrict our clients' ability to raise investor capital to build, maintain or rehabilitate low-income housing via partnerships which are structured to insure that the syndicated housing remains available at affordable rents to low-income people.

The thrust of proposed §102(a)(2) is to apply the anti-abuse provisions of Internal Revenue Code §168(j)(4) (all citations are to the Internal Revenue Code) to partnerships with taxable and tax-exempt partners which are subject to §168(j)(9). We believe that this proposed expansion is not a technical change both because it was not proposed during the legislative process which led to the Tax Reform Act of 1984 and because it is not necessary to remedy the problem which §168(j)(9) was enacted to correct.

The following example illustrates the type of venture our clients often participate in:

> A is a nonprofit organization which is exempt from federal income tax. A owns and operates H which is a low-income housing project. To raise capital to build additional housing A sells H to P, a limited partnership set up to operate H as low-income housing. P's managing general partner is B. B is a taxable nonprofit organization whose purpose is to operate low-income housing. B's directors are appointed on an on-going basis by A. B holds an "unqualified allocation" under §168(j)(9) because it has a 1% allocation of P's operational income or loss but 25% allocation of P's gain arising from the sale of H.

A established B to insure that H remains low-income housing both while owned by P and, if economically possible, when H sells P. A and B expect that B will be taxed as to any gain it may realize and that it will use any after-tax dollars to develop and preserve low-income housing.

Under the Tax Reform Act of 1984 B's unqualified allocation of gain was not within the scope of §168(j) because B was not tax-exempt and the provisions of §168(j)(4)(E) did not impute tax-exempt status to B. Additionally, the Tax Reform Act of 1984 did not apply related party rules to partnerships. Thus, a taxable subsidiary or affiliate of a tax-exempt organization did not have tax exempt status imputed to it merely because of a relationship to a tax-exempt organization.

Under the changes proposed by the Technical Corrections Act both B and P, who are engaged in operating low-income housing, may be successors under §168(j)(4)(E)(iii) to A, which also operates low-income housing. Neither the statute, its legislative history, nor other provisions of the Internal Revenue Code indicate what relationship must exist between organizations which, when combined with "engaging in activities substantially similar" in nature, results in predecessory/successor relationship between those organizations. For the sake of discussion we will assume that B is such a successor, under §168(j)(4)(E)(iii), to A, but that P is not. Because B is a successor it succeeds to A's treatment under §168(j)(4)(E)(1), which is to be treated as a tax-exempt entity. The effect of this recharacterization is as follows.

Twenty-five percent of H is now, under §168(j)(9)(C)(ii), treated as "tax-exempt use property" with a 40-year useful life for depreciation purposes. This recharacterization will reduce the amount of equity which investors will be willing to invest in P, and correspondingly, the amount of cash available to P to pay to A as part of the purchase price of H. This is the result despite the fact that B is both fully taxed on all income it realizes as P's managing general partner and that this income does not inure to A's benefit. Additionally, the overally federal tax paid by B's partners is increased by the reduction in its depreciation deductions but again there has been no corresponding benefit to A or any other tax-exempt entity.

The illogical nature of results which would flow from the proposed change become clearer when these results are contrasted with a virtually identical scenario. If we assume that B is tax-exempt but that its involvement in P constitutes an unrelated trade or business, §168(j)(3)(D) makes it clear that the partnership is outside the scope of §168(j). There is no logical reason why the result should be different if B is a taxable successor to a tax-exempt entity. In short, §102(a) of the Technical Corrections Acts seems to be a solution without a problem. This conclusion is confirmed when one considers that §168(j)(9) was enacted to prevent the use of partnership allocations which direct all distributable cash to tax-exempt partners and all tax losses to the taxable partners in the same partnership. Section 168(j))9) already effectively remedies that situation.

As detailed above, it is unclear at what tax system abuses the changes proposed at §102(a)(2) of the Technical Corrections Act of 1985 are aimed. However, if the Congress wishes to enact §102(a)(2) as proposed we request that it also take the following steps:

1. Define the relationship between organizations necessary to a finding of successor/predecessor status under §168(j)(4)(E)(iii);

2. Define what is a "substantially similar activity" with particular emphasis on what portion of the organizations' activities must be comparable and whether unrelated business activities are included in the analysis; and

3. Consistent with §168(j)(3)(D), provide for an irrevocable election by a tax-exempt entity, binding on its assignees and transferees, to treat all income, derived through its participation in a partnership, as unrelated trade or business income taxable under §511. This election would allow a tax-exempt organization to participate in a commercial undertaking such as P without establishing a taxable affiliate or subsidiary.

These steps would clarify how, and at what tax cost, tax-exempt organizations might utilize taxable commercial undertakings that assist them in fulfilling their tax-exempt goals and purposes while insuring that any economic benefit derived from such undertakings would be fully subject to federal law.

Respectfully submitted,

Roberta Youmans for
Richard W. Power
National Housing Law Project

STATEMENT OF THE
GOVERNMENT OF THE NETHERLANDS ANTILLES
SUBMITTED FOR THE RECORD OF
COMMITTEE ON FINANCE
U.S. SENATE
HEARINGS ON S.814
THE TECHNICAL CORRECTIONS ACT OF 1985

The Government of the Netherlands Antilles submits this statement for the record commenting on section 110(d)(2) of S. 814, the "Technical Corrections Act of 1985," as section 110(d)(2) directly affects the Netherlands Antilles.

This section would amend the safe harbor for past years for U.S.-owned Netherlands Antilles international finance subsidiaries enacted as part of the section of the Deficit Reduction Act of 1984 repealing the U.S. withholding tax on portfolio interest paid to foreigners. 1/ The safe harbor was designed to avoid U.S. Internal Revenue Service audit challenge of pre-existing Netherlands Antilles Eurobond issues meeting certain requirements as part of an effort to encourage such issues to remain in the Netherlands Antilles after repeal. 2/

1/ Pub. L. No. 98-369, § 127 (codified principally in sections 871(h) and 881(c) of the U.S. Internal Revenue Code). The safe harbor provisions are found in §127(g)(3).

2/ As detailed below, other provisions designed to encourage issues to remain in the Netherlands Antilles were the effective date of repeal (obligations issued after enactment) and the effective date of the resourcing provisions for the U.S. foreign tax credit (1992 for certain issues outstanding on March 31, 1984 of Netherlands Antilles international finance subsidiaries).

Section 110(d)(2) would amend the safe harbor to make it applicable to foreign-owned Netherlands Antilles international finance subsidiaries as well as for U.S.-owned companies. However, the Netherlands Antilles must take strong exception to the proposed addition to the safe harbor denying affiliated U.S. borrowers U.S. tax deductions for the incremental interest charged by foreign-owned Netherlands Antilles international finance companies. This condition would undermine the Congressional purpose to moderate the repeal's serious adverse economic impact on the Netherlands Antilles and is also objectionable for the further reasons stated below.

Congress Intended that Existing Eurobonds Stay in the Netherlands Antilles

In enacting the repeal legislation, the U.S. Congress was concerned about the inevitable negative consequences to the Netherlands Antilles international financial sector. This sector has depended to a substantial degree on Eurobond issuance activities by Netherlands Antilles international finance subsidiaries, and other investment into the U.S., conducted under the aegis of the income tax treaty between our two countries (the "Treaty"). The use of international finance subsidiaries located in the Netherlands Antilles developed and continued with the explicit or de facto support of the U.S. Treasury, as Deputy Assistant Secretary

(Tax Policy) J. Roger Mentz observed in his testimony before the House Ways and Means Committee. As the Netherlands Antilles has previously advised the U.S. Congress, its international financial sector is the single largest contributor to government revenues, accounting for 57% of the Netherlands Antilles Federal budget and 25% of the combined Federal and Curacao budgets.3/ Moreover this sector is a key source of foreign exchange -- our means of importing the foreign goods and services on which we depend due to our limited natural resources -- and provides substantial employment. Because of recent reverses in other basic sectors -- such as the closing of the Exxon oil refinery in Aruba which is estimated to result both in a 35% decrease in Aruba's gross national product and a 25% increase in its unemployment; ongoing discussions concerning a reduced level of operations and employment at the only other refinery in

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3/ Tax Treatment of Interest Paid to Foreign Persons: Hearing on H.R. 3025 and H.R. 4029 Before the House Committee on Ways and Means, 98th Cong., 2d Sess. 118, 124-25 (May 1, 1984; Serial 98-84) (Statement of Dominico F. Martina, Prime Minister of the Netherlands Antilles). This hearing will hereafter be referred to as the "Repeal Hearing."

our country, namely the Shell refinery in Curacao; and the continuing slump in tourism -- the viability of the international financial sector is more crucial than ever to the Netherlands Antilles.4/

To mitigate the economic hardship to the Netherlands Antilles stemming from the repeal, the Senate Bill would have provided a transitional incentive to new Eurobond issues through the Netherlands Antilles rather than by the direct U.S. route. On the other hand the Senate Bill would have permitted pre-enactment Eurobond issues by Netherlands Antilles international finance subsidiaries to be assumed by the U.S. parent companies. Thus while the Senate Bill sought to help the Netherlands Antilles by temporarily favoring new issues through the Netherlands Antilles, it permitted erosion of existing issues by assumptions.

4/ Notably, the U.S. Treasury has acknowledged the severe result for the Netherlands Antilles involved in the repeal and has stated the object to ease that situation. At the May 1, 1984 hearing before the House Ways and Means Committee, then Deputy Assistant Secretary (Tax Policy) Ronald A. Pearlman publicly stated in response to the concerns expressed about the effect on the Netherlands Antilles that Treasury's support for the repeal was "unrelated to the Netherlands Antilles or to the international finance subsidiaries." Repeal Hearing at 38. Mr. Pearlman went on to say, "We are sensitive to the problem of the Antilles. We would hope that through the continued treaty negotiations and through the other efforts that hopefully this Government would make in dealing with the Antilles, that the effect will be softened." Id.

Ultimately, the Congress chose a different approach to serve both the interests of promoting the direct access and softening the blow to the Netherlands Antilles -- namely the repeal was made prospective only so that the old Eurobonds would continue in the Netherlands Antilles and not be removed through assumptions. This meant that the Netherlands Antilles international financial sector -- which would lose the lion's share of the post-repeal Eurobond issuance business by reason of issuances directly from the U.S. -- would still maintain the pre-repeal business, thereby mitigating somewhat the economic blow. 5/

Consistent with requiring Eurobond facilities to remain in the Netherlands Antilles, Congress modified the resourcing rules to ensure that U.S. parent companies would obtain U.S. foreign tax credits for Netherlands Antilles taxes on

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5/ Although Congress therefore no longer saw the need to favor new issues through the Netherlands Antilles as under the Senate Bill, nevertheless it is fair to conclude that there was no intent or reason to stop companies from using the Netherlands Antilles as an alternative route for new Eurobond issues as long as U.S. companies have the option of direct access to the Eurobond market. Congress did see fit by means of the resourcing provisions to limit the availability of foreign tax credits with respect to Netherlands Antilles international finance subsidiaries, so that the choice of the Netherlands Antilles route would not provide a tax advantage over direct access, but did not otherwise act to dissuade companies from utilizing the Netherlands Antilles route or shut down other legitimate investment into the U.S. from the Netherlands Antilles international financial sector.

the grandfathered international finance subsidiaries' income from lending the proceeds of pre-repeal Eurobonds. 6/

To complete the third leg of the purpose to keep existing Eurobond issues in the Netherlands Antilles, Congress added the safe harbor -- the subject of the correction proposed in section 110(d)(2). For 10 years up to 1974 the IRS issued favorable rulings sanctioning Eurobond issues through the Netherlands Antilles. Thereafter for another 10 years Eurobond activity through the Netherlands Antilles continued on the basis of opinions of counsel with the de facto support of the U.S. Treasury (acknowledged by Deputy Assistant Secretary Mentz in his testimony before the House Ways and Means Committee). When a technical concern about the creditability for U.S. tax purposes of the Netherlands Antilles tax paid by U.S.-owned international finance subsidiaries arose in 1980, the IRS published a ruling7/ to alleviate the concern and Netherlands Antilles issues continued. In very recent years, however, the IRS has made challenges on audit to alleged abuses of the Treaty. Thus Congress legislated the safe harbor to solve the pre-repeal audit cases as part of the package to keep pre-repeal Eurobond issues in the Netherlands Antilles.

6/ Deficit Reduction Act of 1984, § 121(b)(2). It is noted that the exception to resourcing applies only in the case of certain Eurobonds outstanding on March 31, 1984, and expires January 1, 1992.

7/ Rev. Rul. 80-4, 1980-1 C.B. 169.

Proposed Widening of the Safe Harbor -- Avoiding Misinterpretation

The technical construction of the the safe harbor enacted last year is such that it does not apply in the case of foreign-owned Netherlands Antilles international finance companies. Section 110(d)(2) would, along with the additional provision on deductibility discussed below, make the safe harbor apply in the foreign-owned case.

The Netherlands Antilles would like to state that in the event Congress decides to broaden the safe harbor provision, appropriate care should be taken not to leave the misimpression that, absent the safe harbor, the law would have been adverse to typical Netherlands Antilles structures. In legislating the original safe harbor provision, Congress made clear that no inference -- one way or the other -- should be drawn regarding the proper resolution of other tax issues. 8/ Similarly, should it be enacted the legislative history of section 110 (d)(2) should confirm that the safe

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8/ H.R. Rep. No. 98-861 (Conference Report on Deficit Reduction Act of 1984), 98th Cong., 2d Sess. 938 (1984).

harbor as modified is not to be construed as reflecting on the merits in other cases. 9/

9/ In October 1984 the IRS issued two revenue rulings holding that interest paid by U.S. subsidiaries of a Swiss and a U.S. parent, respectively, to a Netherlands Antilles subsidiary of that parent on certain obligations did not qualify for the Treaty exemption from the 30% U.S. withholding tax. Rev. Rul. 84-152, 1982-42 I.R.B. 8; and Rev. Rul. 84-153, 1984-42 I.R.B. 9, in which the Netherlands Antilles company had raised the funds for the loans to the U.S. affiliate in Eurobond offerings. These rulings signal an aggressive IRS audit stance on those cases not covered by the safe harbor. The consensus of the U.S. tax experts, and the view of the Netherlands Antilles, is that the rulings are overbroad and go beyond the legal precedents; the need for their clarification has been urged. E.g., Fogarasi & Renfroe, "Is the Benefit of the U.S.-Netherlands Antilles Treaty Terminated for Financing Companies?", 13 Tax Mgmt. Int'l. J., 442 (Dec. 1984); Fuller, Rev. Ruls. 84-152, -53 Captive Finance Companies," 60 Taxes Int'l. 74 (Oct. 1984); Guttentag, "IRS Discloses New Position Regarding Treaty Benefits," VII Can. L. Newsletter 55 (Jan. 1985). The Tax Committee of the United States Council for International Business also wrote to the IRS on January 18, 1985 expressing similar views.

Practical testimony to the weight of authority contrary to the thrust of Rev. Rul. 84-153 is that, based on opinion of counsel, some 200 U.S. corporations have used the Treaty since 1973 to issue over $34.5 billion in Eurobonds.

These rulings are also in conflict with the intent of Congress in enacting the "repeal legislation" since Congress clearly sought to create direct access for U.S. companies to the Euromarket and not to disallow access through the Netherlands Antilles. This intent of Congress is incidentally acknowledged by the Treasury Department as indicated in note 10.

Denial of Deductions is Inappropriate

Section 110(d)(2) as now defined would impose an additional condition on the availability of the safe harbor to foreign-owned Netherlands Antilles companies as compared to U.S.-owned companies. Namely, borrowing U.S. affiliates would be denied U.S. tax deductions for a portion of interest charges paid to foreign-owned Netherlands Antilles finance companies. The amount to be denied would reflect the "spread" between the interest rate charged to the U.S. affiliates and the interest rate at which the Netherlands Antilles company borrowed on the Eurobond market. For the following reasons the Netherlands Antilles protests the proposed condition, and strongly urges that the U.S. Congress reject it.

A. Denial of Deductions Conflicts With Congressional Intent

Denying U.S. affiliates' deductions conflicts with Congressional intent to keep existing Eurobond activities in the Netherlands Antilles by creating additional U.S. tax costs for foreign-owned affiliated groups maintaining pre-repeal facilities in the Netherlands Antilles. This denial of deductions would furthermore be paramount to disallowing future activities of international finance subsidiaries through the Netherlands Antilles which also conflicts with both Congressional intent and the intent of the U.S. Treasury Department. The purpose or intent of the repeal legislation was to provide U.S. companies direct access to the Eurobond market10/ not to deny access through the Netherlands Antilles.

B. Flawed Rationale for Denying Deductions

The rationale stated for denying deductions in the foreign-owned case is to achieve parallel results to the subpart F inclusion of the spread income in the U.S.-owned case. This ignores, however, that by reason of the above-mentioned exception to the resourcing rules, U.S.-owned groups will generally continue to enjoy foreign tax credits for the Netherlands Antilles tax (at about a 30% rate) on the spread income attributable to lending pre-repeal Eurobond proceeds. These foreign tax credits will largely offset U.S. tax liability on the spread income.

Thus -- far from placing foreign-owned companies on a parity with U.S.-owned companies -- denying deductions for the spread discriminates against foreign-owned companies. These companies would end up with double U.S. and Netherlands Antilles taxation of the same spread income.

10/ Statements of J. Roger Mentz, Deputy Assistant Secretary (Tax Policy) before the House Committee on Ways and Means, May 16, 1985 (page 17 third paragraph), and before the Senate Committee on Finance, June 5, 1985 (page 16 fourth paragraph).

C. Denial of Deductions Contrary to Tax Norms

The Netherlands Antilles believes that denying deductions because foreign-owned groups are not subject to U.S. subpart F rules would in any event be contrary to international tax norms. Under those principles, deductions for interest paid an affiliate on an otherwise legitimate loan may be disallowed only to the extent an arm's length rate is exceeded. 11/ There is no reason to assume that foreign-owned Netherlands Antilles international finance companies charged more than arm's length rates on pre-repeal loans of the proceeds of their Eurobond offerings, notwithstanding that the loan rates were in excess of the Eurobond rates.

Indeed the contrary seems obvious -- that an arm's length rate must have included a spread over and above the Eurobond rate. Prior to the repeal U.S. borrowers could not have obtained loans at Eurobond rates from unrelated lenders. As a minimum, unrelated foreign lenders would have grossed-up the Eurobond rate by an amount to reflect the 30% U.S. withholding tax. Alternatively, rates available from unrelated U.S. lenders also would have greatly exceeded the Eurobond rates. Representatives of the U.S. securities industries have submitted data to Congress showing that during the period preceding the repeal the cost of funds in the U.S. domestic public market

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11/ Organisation for Economic Co-operation and Development, Transfer Pricing and Multinational Enterprises 90-93 (1979). Under U.S. law this principle is codified in section 482 of the U.S. Internal Revenue Code.

consistently exceeded Eurobond costs; this spread in costs often approached, and in cases surpassed, one percentage point. 12/

D. Denial of Deductions Inconsistent With Treaty

In 1963 our two countries negotiated a Protocol to the Treaty. At the insistence of the U.S. the Protocol required that in order for foreign-owned Netherlands Antilles companies (other than wholly Dutch-owned companies) to be entitled to withholding rate exemption (or reduction) under the Treaty, the companies must pay Netherlands Antilles tax at full rates (about 30% in the case of interest income). The Netherlands Antilles must certify whether a company complies with the Protocol's requirement.

The Netherlands Antilles does not certify compliance unless a company agrees to a minimum spread in the case of loans of Eurobond proceeds. 13/ Obviously in the absence of

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12/ Repeal Hearing at 89-91 (statistics on cost savings in the Eurodollar bond market in 1982-83 compiled by the Securities Industry Association) and 287-288 (similar statistics for 1983 and first four months of 1984 submitted by Avon Products, Inc.).

13/ The U.S. has been aware of the Netherlands Antilles spread requirement and, in fact, has confirmed the appropriateness of the requirement in the context of ongoing discussions with the Netherlands Antilles.

such agreement, the Protocol's purpose -- that treaty-benefitted companies should bear a significant Netherlands Antilles tax -- would be defeated.

The implication of the proposed denial of the deduction for the spread, however, is that the Netherlands Antilles should not be taxing this income. 14/ This would mean that the foreign-owned companies would be enjoying the Treaty withholding tax exemption for the entire interest paid by the U.S. affiliate without bearing any Netherlands Antilles tax. This result -- besides unfairly denying the Netherlands Antilles an appropriate part of its tax base -- would clearly be inconsistent with the 1963 Protocol.15/

E. Denial of Deductions is Substantive Not Technical

Chairman Packwood has stressed that this legislation should not become the vehicle for substantive changes as distinguished from technical corrections. The denial of

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14/ The alternative, already mentioned above, would be double taxation by both the Netherlands Antilles and the U.S.

15/ The Netherlands Antilles notes that the practice of companies under the existing safe harbor has already pinched the Netherlands Antilles tax base. In the past companies typically maintained a 3 to 1 or lower debt-equity ratio. However, the safe harbor adopted in the 1984 legislation permits a 5 to 1 ratio. Many companies are taking advantage of this latitude at the expense of the Netherlands Antilles revenue.

deductions for part of the interest paid to Netherlands Antilles finance companies was not included in the safe harbor provision enacted in 1984. To deny deductions in this legislation would substantively change the tax rules that otherwise would govern past transactions without any basis for doing so in the original legislation, and so fails to meet the Chairman's admonition.

* * *

In conclusion, the Netherlands Antilles strongly urges that Congress reject the provision denying deductions for the spread as contrary to Congressional intent, international tax norms, the Treaty and the purpose of the legislation.

Respectfully submitted,

Harold Henriquez,
The Minister Plenipotentiary
for Netherlands Antilles
Affairs

June 12, 1985

NORTHEAST MARYLAND
WASTE DISPOSAL AUTHORITY

MEMBERS: Parker Andrews, Anne Arundel County; Richard H. Trainor, Baltimore City; Gene L. Neff, Baltimore County; Todd E. Stevenson, Harford County; John D. Seyffert, Maryland Environmental Service
Robert F. Schoenhofer, Executive Director

JUNE 3, 1985

TESTIMONY OF ROBERT F. SCHOENHOFER, EXECUTIVE DIRECTOR OF THE NORTHEAST MARYLAND WASTE DISPOSAL AUTHORITY ON THE TECHNICAL CORRECTIONS ACT OF 1985

I am Robert F. Schoenhofer, Executive Director of the Northeast Maryland Waste Disposal Authority. I am submitting this testimony because the Authority believes that Congressional clarification is needed so that a "federal guarantee" provision in the tax-exempt bond sections of the 1984 Tax Act is not incorrectly applied to proscribe the financing of either the Harford County/Aberdeen Proving Ground or the Annapolis/U. S. Naval Academy waste-to-energy facilities. The Authority seeks an amendment to the Technical Corrections Act of 1985 essentially in the form of recently introduced S.B. 981 which I have attached to my testimony.

The projects will be financed by the Northeast Maryland Waste Disposal Authority. The Authority is a public instrumentality of the State of Maryland formed on July 1, 1980 to develop regional solid waste disposal projects. Over the past four years, the Authority has expended approximately $850,000 to develop the Harford County Waste-to-Energy Facility. The Authority has substantially completed its development activities and the project can be financed and construction commenced this year. The facility would provide Harford County and the U. S. Army's Aberdeen Proving Ground with a long-term, environmentally sound solution to their solid waste disposal needs and will produce steam for sale to the Aberdeen Proving Ground pursuant to a long-term contract. It is anticipated that the U. S. Army will save over 3.5 million gallons of oil each year as a result of its use of steam generated from solid waste.

The Authority has also been developing the Annapolis Waste-to-Energy Facility during approximately the last three years, has expended approximately $250,000 in the process and has purchased land to be used as a site for the facility. The Annapolis facility would provide the City of Annapolis, Anne Arundel County, Queen Anne's County, and the U. S. Naval Academy with a long-term solution to their solid waste disposal needs and provide the U. S. Naval Academy with a reliable source of steam which would allow the U. S. Navy to save the equivalent of 3 million gallons of fuel oil annually.

131 EAST REDWOOD STREET, SUITE 503, BALTIMORE, MARYLAND 21202-1275 301/659-2730

It should be noted that the military procurement authorization laws in recent years have expressed Congress' intent that third party financing and ownership of energy facilities, including waste-to-energy, be encouraged and that direct federal appropriations be used only when that alternative has been exhausted. The Harford County and Annapolis projects have been the subject of thorough negotiation and hard bargaining with the U. S. Army and U. S. Navy.

In the course of developing new restrictions on tax-exempt bonds, the Congress focused on certain transactions in which federal agencies provide the security for tax-exempt bonds through guaranteeing the obligations, such as a transaction where bond proceeds are deposited in banks or savings and loans to be loaned to the bond user. Under this arrangement, the bond holders, in effect, were insured by the FDIC or the FSLIC. There are other federal programs run by agencies such as the SBA, HUD, the FHA and the VA in which the federal government also pledges or guarantees the repayment of bonds by other parties although no service is provided to the federal government. The tax-writing committees were concerned that a special subsidy was being provided in these cases creating a favored class of obligation.

The Authority currently has a ruling request pending with the IRS concerning the tax-exemption of bonds to be issued for the Harford facility. The IRS has indicated that it cannot give the project a favorable ruling because of the fact that revenues from the long-term steam sales with the U. S. Army, which may be available to the operator of the Harford facility to pay debt service on the bonds, may constitute a federal guarantee. Had the Authority known that the IRS would take this position, it would have requested an exemption for its two projects in the 1984 Tax Act as several other projects did successfully at that time.

The energy contracts with the military for the Authority's two projects contain provisions under which the military base pays for certain minimum quantities of energy if and only if the energy is made available by the energy supplier. This type of arrangement is necessary for the financial security of any project. The provision is not a guarantee of the principal and interest on the bonds but is simply a contractual commitment to pay for certain minimum quantities of energy in consideration for receiving access to a secure supply. This is not a "hell or high water" provision which requires government payments even if a facility is not built or energy is not available. Nor is a special bond class created. This type of provision does not cause the bonds to receive a higher credit rating than they otherwise would receive.

It is anticipated that all of the steam from the Harford facility will be sold to the Aberdeen Proving Ground and that the proceeds of the steam sales, together with waste disposal fees paid by Harford County, will be used to pay the operating expenses of the Harford facility, including debt service on the bonds. The U. S. Army, however, is not obligated to make payments under the steam purchase contract unless steam is produced and made available to it. Because of the real business risks which could prevent the facility operator from providing steam to the U. S. Army, the payment of the principal and interest on the bonds is by no means guaranteed by the Federal government. A similar steam purchase contract is being negotiated with the U. S. Navy for the purchase of substantially all of the steam from the Annapolis facility.

According to the general explanation of the 1984 Tax Act prepared by the Staff of the Joint Committee on Taxation: "Congress intended that the determination of whether a federal guarantee exists be based on the underlying economic substance of the transaction, taking into account all the facts and circumstances in this regard. A transfer or risk to the Federal government is a key element in determining whether such a guarantee exists." Under the Aberdeen Proving Ground and Naval Academy contracts, financial, technological and operating risk of loss, other than that covered by premature termination by the government, lies with the project. Under the 1984 Tax Act's special service contract rule for solid waste disposal facilities, the service recipient (military base) cannot bear significant financial risks. The projects intend to comply fully with the special service contract rules.

In order to permit the financing of the Harford County and Annapolis facilities, the Authority requests clarification that the federal guarantee provisions do not apply to the bonds for these projects. Immediate action is necessary so that both of these worthwhile projects can move forward without substantial delay which will as a practical matter prevent their development.

033/044E

II

99TH CONGRESS
1ST SESSION

S. 981

To provide that section 103(h) of the Internal Revenue Code of 1954 shall not apply to any obligation issued to finance certain solid waste disposal facilities.

IN THE SENATE OF THE UNITED STATES

APRIL 23 (legislative day, APRIL 15), 1985

Mr. MATHIAS (for himself, Mr. SARBANES, Mr. WARNER, and Mr. TRIBLE) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To provide that section 103(h) of the Internal Revenue Code of 1954 shall not apply to any obligation issued to finance certain solid waste disposal facilities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. CERTAIN OBLIGATIONS USED TO FINANCE SOLID WASTE DISPOSAL FACILITIES NOT TREATED AS FEDERALLY GUARANTEED.

(a) IN GENERAL.—Any obligation which is part of an issue a substantial portion of the proceeds of which are to be used to finance a solid waste disposal facility described in subsection (c) shall not, for purposes of section 103(h)(1) of the Internal Revenue Code of 1954, be treated as an obligation which is federally guaranteed.

(b) LIMITATION ON DOLLAR AMOUNT.—The aggregate face amount of obligations to which subsection (a) applies with respect to any State shall not exceed $65,000,000.

(c) SOLID WASTE DISPOSAL FACILITIES TO WHICH SECTION APPLIES.—A solid waste disposal facility is described in this subsection if such facility is described in section 103(b)(4)(E) of the Internal Revenue Code of 1954 and—

(1) a public State authority created pursuant to State legislation which took effect on July 1, 1980, took formal action before October 19, 1983, to commit development funds for such facility,

(2) such authority issues obligations for such facility before January 1, 1988, and

(3) expenditures have been made for the development of such facility before October 19, 1983.

Risk and Insurance Management Society, Inc.

President
P. RICHARD HACKENBURG
Staff Vice President & Assistant Treasurer
Allegheny International, Inc.
Two Oliver Plaza
Pittsburgh, Pennsylvania 15222
(412) 562-4287

First Vice President
WILLIAM L. MATHER
Administrator of Risk Management
The Gillette Company
3800 Prudential Tower Building
Boston, Massachusetts 02199
(617) 421-7742

Vice President-Business
& Industry Liaison
RONALD M. WINANS
Vice President, Administrative Services Group
J.R. Simplot Company
P.O. Box 27
Boise, Idaho 83707
(208) 336-2110

Vice President-Communications
GLENN A. MacCORKLE
Risk Manager-
Planning & Administration
United Technologies Corporation
One Financial Plaza
Hartford, Connecticut 06101
(203) 728-7662

Vice President-Conference
WOODROW B. ANDERSON
Operating Vice President-Risk Management
Federated Department Stores, Inc.
7 West Seventh Street
Cincinnati, Ohio 45202
(513) 579-7060

Vice President-Education
DANIEL W. HOUSTON
Director, Risk Management & Insurance
NCR Corporation
1700 South Patterson Blvd.
Dayton, Ohio 45479
(513) 445-1315

Vice President-Finance & Treasurer
RONALD W. STASCH
Corporate Risk Manager
Federal Mogul Corporation
P.O. Box 1966
Detroit, Michigan 48235
(313) 354-4381

Vice President-Governmental Affairs
RICHARD C. HEYDINGER
Risk Management Director
Hallmark Cards, Inc.
2501 McGee
Kansas City, Missouri 64108
(816) 274-8540

Vice President-Member Affairs & Secretary
ARTHUR P. BOSTWICK
Risk Manager
Stone Container Corp.
360 North Michigan Avenue
Chicago, Illinois 60601
(312) 346-6600

Vice President-Research
CHERI J. HAWKINS
Assistant Director of Insurance
Weyerhaeuser Company
Tacoma, Washington 98477
(206) 924-2042

Executive Director
RON JUDD

24th Annual RIMS Conference
Toronto, Canada • April 13-18, 1986

June 12, 1985

Betty Scott-Boom, Esquire
Tax Counsel
Committee on Finance
Room SD-219
Dicksen Senate Office Building
Washington, D.C. 20510

Re: Comments for Hearing on S. 814 Technical Corrections Bill -- Impact of Section 7702(a) on Qualification of Self-Insured Plans as Life Insurance Under Section 101(a)

Dear Ms. Scott-Boom:

The following comments are submitted for inclusion in the printed record of hearings held on June 5, 1985 by the Senate Finance Committee on S. 814, proposing technical corrections to the 1984 Tax Reform Act.

The Risk and Insurance Management Society, Inc., commonly known as RIMS, is a non profit association representing corporate, governmental, and institutional self insurers and consumers of insurance in over 76 chapters throughout the United States and Canada. Our members, which include over 92% of the Fortune 500 Companies, account for the purchase of more than $35 billion of insurance and benefit services annually.

RIMS is deeply concerned that Section 7702(a) may unfairly discriminate against the employees of RIMS members receiving benefits under an employer funded life insurance plan.

Summary

Section 7702(a), if not clarified, could upset relatively well-settled law concerning the tax treatment of employer maintained life insurance plans. In this regard, the following points are relevant:

205 East 42nd Street, New York, N.Y. 10017 • (212) 286-9292
Telex: 968280 • FAX (212) 986-9716

- The Section 101(a) exclusion from gross income for life insurance proceeds has typically been applied to self-insurance under prior law, where certain aspects of insurance are present.
- The aspects of insurance under the law for tax purposes are (1) risk shifting and risk distribution; (2) actuarial soundness; and (3) a binding obligation to pay.
- Prior law did not require contracting with an unrelated insurance company as a condition of qualification as insurance.
- There is no justification for imposing such a requirement under Section 7702(a), which was not intended to address this issue.
- As presently drafted, depending on the laws of each state, Section 7702(a) could be interpreted to deny qualification to employer maintained life insurance plans under Section 101(a), thus discriminating against self-insurers and providing an unfair advantage to commercial life insurance companies.

Proposal

We propose a clarification of Code Section 7702(a) with respect to the definition of a "life insurance contract", to clarify that Section 7702(a) was not intended to preclude the qualification of death benefits paid under a self-insured employer plan as "amounts received... under a life insurance contract" within the meaning of Section 101(a)(1). The following underlined portion is proposed as an amendment to Section 7702(a) to clarify its application to certain death benefits:

> (a) GENERAL RULE -- For purposes of this title, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law, without regard to any requirement under applicable law that such a contract be issued by an insurance company, but only if such contract... .

The proposed technical correction would guarantee that Section 7702(a), which was intended to prevent investment-type contracts (*e.g.*, "universal life insurance") from qualifying for favorable tax status as life insurance, will not be interpreted to discriminate against self-insurers by requiring them to purchase coverage from a life insurance company to qualify under Section 101(a). This would permit an employer's decision whether to self-insure an employee life insurance plan to continue to be made on a tax-neutral basis, and would avoid conferring an unfair advantage on life insurance companies.

Section 101(a)

Section 101(a)(1) provides in pertinent part as follows:

> [G]ross income does not include amounts received... under a life insurance contract, if such amounts are paid by reason of the death of the insured.

The term "life insurance contract" is not defined in Section 101(a) or the regulations thereunder. However, Treas. Reg. §1.101-1(a)(2) contains a number of cross references to other sections of the Code and regulations pertaining to life insurance contracts and insurance companies, including Sections 72(m)(3) and 801.

Section 72(m)(3) governs the tax treatment of life insurance contracts purchased by a qualified Section 401 and 403 plan. Treas. Reg. §172-2(a)(1), interpreting this provision, provides that it is immaterial whether a contract is entered into with an insurance company, for purposes of classification as a life insurance contract.

Section 801 defines the term "insurances company" as a company predominantly engaged in the issuing of insurance or annuity contracts.

Rev. Rul. 83-172, 1983-2 C.B.107, holds that a self-insured workers compensation arrangement qualifies for taxation as an insurance company under Section 831. In reaching its conclusion that the group in question was conducting an insurance business, the Service reasoned in Rev. Rul. 83-172 that the self-insurance arrangement constituted an insurance contract because it satisfied the essential insurance characteristics of risk shifting and risk distribution.

A number of court decisions have addressed the issue of whether a self-insured plan sponsored by an employer constitutes insurance for tax purposes. These decisions indicate that an employer's plan may be considered an insurance contract if the following elements are present: (1) risk shifting and risk distribution; (2) actuarial soundness; and (3) a binding commitment to pay benefits. *See Helvering v. LeGierse*, 312 U.S. 531 (1941); *Ross v. Odom*, 401 F.2d 464 (5th Cir. 1968) [68-2 U.S.T.C. par. 9587]; *Davis v. U.S.*, 323 F.Supp. 858 (S.D. W.Va. 1971)[71-1-U.S.T.C. par. 9264]; and *Haynes v. U.S.*, 353 U.S. 81 (1957), *rev'g* 223 F.2d 413 (5th Cir. 1956). These factors are discussed in more detail below.

1. *Risk Shifting and Risk Distribution*.

Risk shifting and risk distribution involve:

> the payment of premiums or assessments by a number of individuals into a common fund out of which the payor's estate or beneficiaries will be paid a certain amount upon his death regardless of whether the amount is more or less than the decedent has paid into the fund.

Commissioner v. Tighe, 33 T.C. 557, 564 (1959).

Risk-shifting, as noted by the Second Circuit, "emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and the insured each of whom gamble on the time the latter will die." *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950) [50-1 U.S.T.C. par. 10,770]. Risk distribution, on the hand, emphasizes the "broader, social aspect of insurance as a method of dispelling the danger of the potential loss by spreading its cost throughout the group." *Id.* at 50-1 U.S.T.C. 12,875-91.

In *Commissioner v. Treganowan*, *supra*, the Second Circuit held that a death benefit plan under which the beneficiary of each plan participant would receive a $20,000 lump-sum payment "manifestly" produced a distribution of the risk. *Treganowan*, *supra*, at 50-1 U.S.T.C. 12,875-91. The Court based this conclusion on the fact that more than 1300 persons contributed to the fund from which death benefits were paid, and on the fund's actuarial soundness. *Id.* "Because of the plan," the Court held, "the risk of premature death is borne by the 1,373 other members of the [plan], rather than by the individual."

2. Actuarial Soundness.

Many of the judicial decisions have focused on the need for actuarial soundness for a self-insured plan to be considered "insurance" under the Code. For example, in Ross v. Odom, supra, the contributions to fund the state employee survivor's benefit fund were required by state law to be fixed based on "accepted actuarial computations." As found by the court:

> [O]n accepted actuarial principles, the size and composition of the group, and relevant expectancy and investments factors, the benefits prescribed could be discharged by the Survivors' Benefit Fund. . . . On both scores this was insurance.

68-2 U.S.T.C. at 88,036. See also Edgar v. Commissioner, 39 TCM 816, 822 (1979); Davis v. U.S., 323 F.Supp. 858 (S.D. W.Va. 1971) [71-1 U.S.T.C. par. 9264].

3. Binding Obligation to Pay Benefits.

Another factor emphasized by the courts is that the employer's promise to pay the death benefits in question must not be illusory. See, e.g., Davis v. U.S., supra, at 71-1 U.S.T.C. 86,031 (held, plan which fails to provide "definitely determinable death benefit" is not insurance). For example, where an employer-sponsored plan is terminable, the beneficiary's right to payment of benefits once death has occurred must be fixed and definite. In Ross v. Odom, supra, the court found several factors significant in reaching its conclusion that the life insurance arrangement there constituted a binding, enforceable obligation with assurances that funds to discharge the obligation would be both available and sufficient. Although the arrangement there was terminable, vested claimants were entitled to sue under state law if the claim was not paid. The investments permitted for the fund were carefully restricted and funds were protected by surety bonds. Finally, the contributions of the employers (participating state agencies) were ensured by compulsory budgeting under State law. Id. 68-2 U.S.T.C. at 88,039.

Ross v. Odom was decided prior to the enactment of ERISA (the Employee Retirement Income Security Act of 1974). Like the provisions of state law in Odom, safeguards are provided under ERISA which protect the rights of beneficiaries to receive all appropriate benefits under an employee welfare benefit plan such as a self-insured life insurance plan. ERISA requires that the named fiduciary of the Plan must operate the Plan prudently and in the interest of all participants and beneficiaries. ERISA §404(a)(1). The named fiduciary is obligated under ERISA to discharge his or her duties with respect to a plan "for the exclusive purpose of providing benefits to participants and their beneficiaries; and defray reasonable expenses of administering the plan". ERISA §404(a)(1)(A). Pursuant to ERISA, moreover, a beneficiary whose claim for benefits is ignored or denied, in whole or in part, can file suit in state or federal court to recover any benefits payable under the plan. ERISA §404(a)(1)(A). These provisions support the conclusion that an employer self-insured plan may qualify as a life insurance contract under the authority of Odom.

4. Qualification of Self-Insurance.

The above result should not be affected by the fact that an employer's plan is not underwritten by a commercial insurance company, or the fact that an employer's accrued liability to make contributions to the Plan is not prefunded or segregated from the employer's general assets. See Haynes v. U.S., 353 U.S. 81 (1957), rev'g 223 F.2d 413 (5th Cir. 1956) [56-1 U.S.T.C. par. 9475], in which the United States Supreme Court held that an employer's self-funded plan qualified as health insurance for purposes of excludability from the income of the employees. The Court in Haynes states:

> The payment of premiums in a fixed amount of regular intervals is not a necessary element of insurance. Similarly, there is no necessity for a definite fund set aside to meet the insurer's obligations.

353 U.S. at 84.

The dissenting opinion in the Court of Appeals decision in Haynes (which was adopted by the Supreme Court in reversing the majority opinion of the Fifth Circuit) sheds further light on the issue of self-insurance. The dissent first notes that commercial insurance is generally more costly, and the government should not be in the position of second-guessing the employer's business decision to avoid such unnecessary costs.

5. Impact of Code Section 101(b).

The relevance of Section 101(b), which permits a limited exclusion of up to $5,000 for a death benefit provided by an employer, must be considered. This issue may be disposed of by examining the nature of the benefit. Section 101(b), in effect, refers to a form of deferred compensation rather than to insurance *per se*. Where an employer-provided arrangement contains the requisite aspects of insurance it constitutes a contract of life insurance within the meaning of Section 101(a) rather than a compensation arrangement under Section 101(b). *Ross v. Odom*, *supra*, 68-2 U.S.T.C. at 88,040.

Thus, it can be seen that, prior to the enactment of Section 7702(a), Section 101(a) could be interpreted to apply to a self-insured death benefit plan sponsored by an employer, provided the requisite aspects of "insurance" were present.

Section 7702(a)

Section 7702(a), added to the Code by the 1984 Reform Act, provides as follows:

> (a) *General Rule*. -- For purposes of this title, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law, but only if such contract --
>
> > (1) meets the cash value accumulation of subsection (b), or
> >
> > (2) (A) meets the guideline premium test of subsection (c), and
> >
> > (B) falls within the cash value corridor of subsection (d).

Subsections (1) and (2) of Section 7702(a) (the "cash value accumulation test", the "guideline premium test", and the "cash value corridor") are relevant only if the contract has an investment feature in addition to pure insurance protection. Thus, these provisions would have no application to an employer-sponsored plan providing only a death benefit without any accumulation of "cash value".

The reference to "this title" means the Internal Revenue Code. Thus, Section 7702(a) would literally apply to the use of the term "life insurance contract" in Section 101(a). If this application were given effect, a new requirement would be imposed for purposes of determining the availability of the Section 101(a) exclusion, *viz*., classification as a life insurance contract under "applicable law." As discussed below, we believe this result was unintended by Congress, and would seriously complicate an area of law that is relatively well settled.

1. "Applicable Law".

The Joint Committee report on the 1984 Tax Reform Act indicates that "applicable law" means applicable State or foreign law. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 646.

The determination of whether an arrangement would constitute a "life insurance contract" under the laws of many states is far from clear. Moreover, even if a reasonably clear determination can be made in a particular state (and assuming the IRS and the taxpayer can both agree, which is by no means certain), a different result might be reached in other states.

This point can be illustrated by briefly reviewing the law of several states. For example, Virgina law provides that "life insurance means... every insurance upon the lives of human beings and every insurance appertaining thereto payable in fixed or variable dollar amounts, or both." Va. Code §38.1-3. Maryland, Georgia, Florida, and Michigan, among others, have adopted similarly broad definitions of the terms "life insurance" and "life insurance contract." See Md. Ann. Code art. 48A, §63; Ga. Code Ann. §33-25-1; Fla. Stat. Ann. §624.602; Mich. Comp. Laws Ann. §24.1602. Georgia law, for example, provides that a contract of life insurance is one whereby the insurer, for a consideration, assumes an obligation to be performed upon the death of the insured . . ." GA. Code Ann. §33-25-1.

In light of these broad statutory definitions, it appears that the obligation under an employer's self-insured plan to pay death benefits to the survivors of participating employees could qualify as a "life insurance contract" in a number of states. A number of courts, in fact, have indicated that self-funded death benefit plans qualify as "life insurance" arrangements. For example, the Second Circuit noted that associations which collect assessments from their members and distribute these funds to the survivors of a deceased member "have always been understood to be insurance." Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950); see also State v. Dane County Mutual Ben. Ass'n., 247 Wis. 220, 19 N.W. 2d 303 (1945)(held, plans which impose assessments on members for purpose of creating a death benefit fund are a form of "life insurance"). A Texas court, moreover, held that a nonprofit association which paid death benefits to the survivors of deceased members was providing an insurance service. State v. Memorial Benev. Soc. of Texas, 384 S.W.2d 776 (Tex. Civ. App. 1964).

A number of state courts have held that employers who offer self-funded welfare benefit plans to their employees are not engaged in the "insurance business". See, e.g. Superintendent of Insurance v. Monsanto, 517 S.W. 2d 129 (Mo. 1974); Mutual Life Insurance Co. of New York v. New York State Tax Commission, 32 N.Y. 2d 348, 298 N.E. 2d 632 (1973) (self-funded life insurance benefits provided to employees). The stated rationale for these decisions, however, was that the employers were simply providing a fringe benefit to their employees, and were not offering insurance services to the public at large. The decisions do not directly or indirectly hold that the benefit plans provided by the employers failed to qualify as "insurance." In many states, there is no statutory definition of the term "life insurance" and no case law indicating whether or not self-funded death benefit plans qualify as "life insurance" contracts. Therefore, in numerous states, it is uncertain whether an employer's plan could qualify as a "life insurance" arrangement.

2. Life Insurance Investment Contracts.

Section 7702 has its origins in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). In response to increased marketing by insurance companies of flexible premium life insurance contracts ("universal life" or "adjustable life" policies), Congress moved to correct what was viewed as a growing loophole. Such policies typically permitted the policyholder to change the amount and timing of the premiums and the size of the death benefit automatically as desired. The Internal Revenue Service had ruled in a January 23, 1981 private letter ruling that the entire death benefit paid under a flexible premium insurance contract is excluded from gross income under Section 101(a), even though the death benefit may reflect a large cash value accumulation and only a small amount of pure insurance protection. Congress was also concerned that the interest on the cash fund was not subject to tax unless the policy was surrendered prior to the death of the insured.

In order to limit tax benefits available to overly investment oriented life insurance policies, TEFRA established temporary guidelines for death benefits under flexible premium policies to be treated as excludible under Section 101(a). Violation of the guidelines would subject the contract to be treated as a combination of term life insurance and an annuity or deposit fund, so that only the term life insurance component would qualify under Section 101(a).

The 1984 Tax Reform Act adopted rules similar to the temporary TEFRA provisions, but somewhat narrower because of the "general concern with the proliferation of investment-oriented life insurance products... ." (Joint Committee Report at p.646.) This concern represents the entire focus of Section 7702. Nowhere in the legislative history is there evidence of any intent to prevent a non-investment oriented self-insured employee death benefit plan provided by an employer from qualifying as a life insurance contract under Section 101(a). Such plans do not involve any tax-free accumulation of cash value, but merely provide a death benefit on the death of the covered employee. Accordingly, if the requisite elements of risk shifting, risk distribution and actuarial soundness are present, Section 7702(a) should not preclude employer plans from qualifying under Section 101(a) solely because of the vagaries of state law.

A possible interpretation of newly enacted 7702(a) of the Internal Revenue Code which may deny the non taxable status to beneficiaries of death benefits under self-funded employer provided arrangements, is not only outside the legislative intent of the statute, but is also clearly contrary to settled case law and existing Code sections. Notwithstanding this particular Code section, however, when Congress begins to consider overall tax reform, RIMS urges this Committee to adopt a more functional criteria of tax deductibility and tax free status than whether a benefit plan or risk financing mechanism is self funded or purchased from an insurance carrier. In the case of a death benefit, the policy behind the Section 101(a) life insurance exclusion is served whether the proceeds come from the employer's plan or a third party insurer. Where is the equity in taxing Widow A for a $20,000 employer provided death benefit, and leaving Widow B's $40,000 insurer provided death benefit untaxed? Similarly, what purpose is served by forcing an employer to purchase potentially more costly insurance from a third party insurer, when the employer can establish an actuarially sound plan on its own, with a binding commitment to pay benefits and losses? Blind adherence to the definition of insurance in these instances is not tax neutral. Rather it promotes inefficiency on the part of American business, and results in needless revenue loss by the Treasury.

Conclusion

Based on the foregoing, we propose the inclusion of an amendment to S. 814 making a further technical correction to the 1984 Tax Reform Act, to specifically clarify that Section 7702(a) shall have no application to the classification of an employer death benefit plan as a life insurance contract under Section 101(a). We suggest the following underlined language be added to the Section 7702(a):

> "(a) GENERAL RULE -- For purposes of this title, the term 'life insurance contract' means any contract which is a life insurance contract under the applicable law, without regard to any requirement under applicable law that such a contract be issued by an insurance company, but only if such contract... ."

Respectfully submitted,

Jon Harkavy

Jon Harkavy, Esquire
Director of Governmental
Affairs

STATEMENT OF
ST. JOHNS RIVER POWER PARK SYSTEM
ON S. 814
THE TECHNICAL CORRECTIONS ACT OF 1985

The St. Johns River Power Park System of Jacksonville, Florida, appreciates this opportunity to submit comments on the Technical Corrections Act of 1985 (S. 814) for inclusion in the June 5, 1985, hearing record. In particular, we wish to advise you of our concerns over the retroactive elimination of the so-called "Construction or Binding Contract" exception for consumer loan bonds in section 169(a)(1) of such Act and the possible effect such provision would have on the St. Johns River Power Park System, a project supported by the Jacksonville Electric Authority ("JEA") and the Florida Power and Light Company ("FPL").

In the Deficit Reduction Act of 1984 (the "1984 Act"), Congress made substantial changes to those provisions of the Code relating to tax-exempt financing, including a provision (section 626(a) of the 1984 Act) which denies tax-exempt status to consumer loan bonds. Under the 1984 Act, a consumer loan bond is defined as any obligation (other than an industrial development bond, qualified student loan bond, or qualified mortgage bond or qualified veterans' mortgage bond) all or a significant portion of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans to a nonexempt person. The internal effective date for this change is contained in section 626(b)(1) of the 1984 Act which provides:

> "(1) IN GENERAL.--Except as otherwise provided in this subsection the amendments made by subsection (a) shall apply to obli-

> gations issued after the date of enactment of this Act. */

The 1984 Act goes on to provide in section 631(c) for general effective dates for those bond provisions without an internal effective date and for specific exceptions to the overall effective dates in the bond subtitle. Section 631(c), thus, currently provides in relevant part:

> "(c) OTHER PROVISIONS RELATING TO TAX-EXEMPT BONDS --
>
> (1) In General -- Except as otherwise provided in this subtitle, the amendments made by this subtitle shall apply to obligations issued after December 31, 1983.
>
> . . . .
>
> (3) Exceptions --
>
> (A) Construction or Binding Agreement -- The amendments made by this subtitle (other than section 621) shall not apply to obligations with respect to facilities --
>
> (i) the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or
>
> (ii) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

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*/ Date of enactment was July 18, 1984. Thus, obligations issued after July 18, 1984, are governed by the new provision.

> (B) Facilities -- Subparagraph (C) of subsection (b)(2)(A) shall apply for purposes of subparagraph (A) of this paragraph."

(Emphasis added.)

In light of the ambiguity of the cross references in the above-cited sections and the changes proposed in the Technical Corrections Act of 1985, a question has arisen as to whether the so-called Construction or Binding Contract exception in current section 631(c)(3)(A) is applicable to consumer loan bonds. That is, would a consumer loan bond issued after July 18, 1984, with respect to facilities the construction of which was begun before October 19, 1983, or with respect to which a binding contract to incur significant expenditures was entered into before that date, be exempt from the new restrictions (i.e., would it remain tax-exempt).

As noted earlier, currently section 631(c)(1) provides a general rule that "except as otherwise provided in this subtitle" (the entire bond subtitle including the consumer loan bond provisions) the amendments made by the subtitle will apply to obligations issued after December 31, 1983. The internal effective dates are among the exceptions referred to in this general rule. Thus, the consumer loan bond effective date in section 626(b)(1) is an exception to this general effective date. Section 631(c)(3) [the Construction or Binding Contract exception] is also an exception to the December 31, 1983, general effective date. Furthermore, since the so-called internal effective dates are amendments made by the subtitle that are not contained in section 621, the internal effective dates (as well as section 631(c)(1)) are superceded by this section. Thus, this Construction or Binding Contract provision is also an exception to the entire tax-exempt bond effective dates provisions, including the consumer loan bond provisions of section 626(a) and (b).

Section 169(a)(1) of the Technical Corrections Act of 1985 would resolve this ambiguity to the detriment of parties who have issued bonds since July 18, 1984, relying upon the Construction or Binding Contract exception and would do so retroactively. Thus, under the Technical Corrections Act the Construction or Binding Contract exception would not be available to facilities financed or to be financed or refinanced with consumer loan bonds. The St. Johns River Power Park System (the "Power Park") is particularly concerned over the possible effect this subsequent retroactive change to the Construction or Binding Contract exception could have on our project.

The Power Park is a coal-fired generating facility, the construction and operation of which is a joint project of the Jacksonville Electric Authority, a political subdivision of the State of Florida, and Florida Power & Light Company, an investor-owned utility. Under the terms of the Joint Ownership Agreement between the JEA and FPL, which was entered into by such parties on April 2, 1982, FPL would receive output capacity from the JEA's 80% ownership interest in the Power Park, in general, for a 40-year period, for as much as (but no more than) twenty-five percent of the name plate capacity of the JEA's ownership interest in the facility. By private letter ruling dated April 8, 1983, to FPL, the Internal Revenue Service ruled that the bonds issued by the JEA under this arrangement would not be industrial development bonds.

Beginning in November, 1982, the JEA began issuing its St. Johns River Power Park System obligations; and to date in excess of $1.05 billion in bonds and $600 million in short-term bond anticipation notes and commercial paper have been issued. The JEA expects to issue approximately $750 million in additional revenue bonds to retire the short-term debt and to complete the project. At this point, over 90% of the construction contracts have been awarded, and those contracts contain various penalties for cancellation thereof. By June, 1984 over $250 million had been spent on construction. Currently, $400 million has been expended. Thus, the JEA and FPL at the time of enactment of the 1984 Act were well into the Power Park project, which had its inception in December, 1976. The feasibility of the project depends heavily on the JEA's ability to finance its ownership interest with tax-exempt revenue bonds.

Section 169(a)(1) of the Technical Corrections Act, by eliminating the Construction or Binding Contract exception for consumer loan bonds in the 1984 Act, at least in our case, could jeopardize a mammoth construction project, the physical construction of which began in December, 1982 and which is not expected to be completed until approximately October, 1988. Should Internal Revenue Code Section 103(o) apply to future bonds issued by the JEA to finance the construction of the Power Park, not only would the financing of the anticipated $750 million of additional bonds be in jeopardy, but also the existing $1.6 billion in tax-exempt securities would be adversely impacted because of the affect of this development upon the feasibility of the Power Park. Further, the possible retroactive effect of the Technical Corrections Act could jeopardize the tax-exempt status of over $450 million in revenue bonds which were issued since July 18, 1984 (the effective date of the 1984 Act) should these obligations be classified as consumer loan bonds.

To attempt to change these provisions retroactively would work the harshest of injustice (a) upon bondholders who have purchased bonds since July 18, 1984, and (b) upon projects which, in customary legislative procedures, would normally have been provided transitional relief. Therefore, we respectfully request that the Committee revise section 169(a)(1) of the Technical Corrections Act of 1985 so as to ensure that an appropriate transitional rule providing for a Construction or Binding Contract exception for consumer loan bonds be available for projects like the St. Johns River Power Park System.

STATEMENT OF THE HONORABLE WILLIAM DONALD SCHAEFER
MAYOR OF THE CITY OF BALITMORE, MARYLAND
SUBMITTED TO THE COMMITTEE OF FINANCE
OF THE UNITED STATES SENATE
June 7, 1985

Mr. Chairman and members of the Committee, I am pleased to submit my statement for the record with respect to your consideration of the Technical Corrections Act of 1985 (S.814). In particular, I wish to urge favorable consideration by the Committee for including a provision in the Technical Corrections Act of 1985 that will grant relief to the City of Baltimore and its taxpayers for the unexpected consequences of the enactment of Section 103(o) of the Internal Revenue Code of 1954 (the "Code") by the Deficit Reduction Act of 1984 ("1984 Tax Act"). This new provision of the Code has made it virtually impossible for the City to use the proceeds of general obligation bonds to be issued by the City to reimburse the City's Treasury for $27,000,000 in advances previously made to initiate certain activities previously approved by the voters for financing with the City's general obligation bonds.

By way of background, the City of Baltimore has made a general practice of marketing a single issue of general obligation bonds each year. The City is perhaps unique in this practice. From 1960 through 1981, these annual bond issues averaged slightly less than $35 million. From 1982 through 1985, in part because of adverse market conditions, the City's annual bond issues have averaged less than $20 million.

An essential component of the City's general obligation borrowing program in past years has been to allocate a portion of the money raised to encourage small businesses, minority undertakings, the renovation of decaying properties, the creation of employment opportunities, and the revitalization of neighborhoods. The City has used borrowed proceeds not only to provide for traditional public improvements, such as streets, schools, firehouses, utilities, parks, etc., but also in a deliberate and strategic manner to encourage private investment. For example, such encouragement in the form of a loan was necessary in the late 1970's to bring the Hyatt Regency Hotel to the Baltimore Inner Harbor. Today, that hotel enjoys the highest occupancy rate of any in the Hyatt chain and is a centerpiece of our spectacular Inner Harbor. In numerous other instances, the City has made loans or guaranteed loans for projects when banks and investors were either unwilling or unable to assume all of the risks. The renaissance of downtown Baltimore and the revitalization of Baltimore's neighborhoods have come about, in large part, because of the City's imaginative investment in public improvements and its financial participation in private investment enterprises with the proceeds of general obligation bond issues.

The activities supported by each issue of the City's general obligation bonds have in every instance been approved by the Maryland General Assembly, the Baltimore City Council, and the voters of Baltimore City in accordance with the requirements of the Maryland Constitution. Once the required legislative and voter approvals have been obtained, it has been the practice of the City, acting pursuant to authority in the City Charter, to advance money from the City's Treasury to initiate the approved activities, without waiting for the bond issue to be prepared and marketed. In every instance, we have expected that the Treasury would be fully reimbursed for these advances from the proceeds of the general obligation bonds. Many of the activities thus commenced with advances of City money meet the terms of Section 103(b)(2) of the Code defining industrial development bonds. However, under Section 103 of the Code and accompanying Treasury Regulations as they existed prior to the 1984 Tax Act, up to 25% of the proceeds of each annual issue of the City's general obligation bonds could be used to reimburse the Treasury for these advances. The City had no notice that this practice would not continue.

There is attached to my statement as Exhibit A a list of the activities commenced with the $27,000,000 in advances from the Treasury. Each of these projects involves the acquisition, construction or improvement of land and depreciable property and, in general, is of a type that could have been financed from the proceeds of tax-exempt industrial development bonds under the applicable provisions of the Code and implementing Treasury Regulations in effect at the time that such financings were undertaken, subject, of course, in the case of any particular project, to the need to comply with applicable limitations, such as the "$10,000,000 limit" for financings under Section 103(b)(6) of the Code and the "low or moderate income" requirements for financings of residential rental properties under Section 103(b)(4)(A) of the Code.

The City did not seek to finance these projects on a piecemeal basis through the issuance of tax-exempt industrial development bonds, first, because financing costs would have been greatly increased on a cumulative basis and would have been prohibitive in the case of many smaller loans, and second, because of the increased administrative burdens and procedural complexities that would have been involved. In particular, substantial efforts would have been involved in selling the bonds on a competitive bid basis after giving appropriate public notice, as required by applicable law in the case of the sale of general obligation bonds, and in providing adequate disclosure to potential investors when bonds are offered in this manner. Further, until the Tax Equity and Fiscal Responsibility Act of 1982 was enacted in September, 1982, the City was effectively prohibited by Revenue Rulings 77-55 and 81-216 from aggregating the required borrowings for several projects into a single composite issue of industrial development bonds, a financing technique that would have lowered the cumulative issuance costs and lessened the administrative and procedural difficulties. In addition, having determined to finance these projects with the proceeds of the City's general obligation bonds as previously described, the City made commitments to various projects without in every case complying with certain procedural requirements applicable only to the issuance of tax-exempt industrial development bonds, such as obtaining "official action" before commencing construction and issuing bonds within one year of the date on which a project is placed in service.

The enactment of Section 103(o) by Section 626 of the 1984 Tax Act defined a new category of "consumer loan bonds", the interest on which is not exempt from taxation. To avoid becoming a consumer loan bond, no more that 5% of the proceeds of any issue of general obligation bonds issued after July 18, 1984 may be used for activities involving loans to non-exempt persons as defined by Section 103(b)(3). What this means for the City of Baltimore is that, for general obligations bonds issued after July 18, 1984, only 5% of the proceeds can be used to reimburse the Treasury for its prior advances.

Although we promptly ceased advancing funds from the Treasury for new activities once the implications of the new Section 103(o) were realized, enactment of Section 103(o) has nonetheless had a disruptive effect on the City's finances. The City has currently advanced from its Treasury $27,000,000 for activites that would fall within the definitions of Section 103(o)(2)(A). Full reimbursment of these funds was anticipated in good faith. If relief cannot be obtained through an amendment to the Technical Corrections Act of 1985, as I am requesting, these funds will have to be taken from other parts of the City's already hard-pressed budget and other City services may have to be curtailed.

In short, prior to the enactment of the 1984 Tax Act, the City's practice with respect to advancing funds from its Treasury to assure the prompt commencement of important developmental activites was both prudent and permissible. Yet now, because of enactment of Section 103(o) without any advance notice, the City is being forced to suffer a financial hardship.

I would like to emphasize that I am not seeking a permanent exemption from the requirements of Section 103(o). The City has and will continue to conform its practices to the new rules established by the 1984 Tax Act. All that I seek here is to obtain relief from the unexpected adverse impact of Section 103(o) on actions taken by the City in good faith prior to enactment of the 1984 Tax Act.

Language that would be suitable for inclusion in the Technical Corrections Act of 1985 is attached to my statement as Exhibit B.

I wish to thank the Committee for considering my request. Further information about my request can be obtained from my staff and, in particular, from David Falk in my Washington office (223-3020) and from James Vroonland in the City's Department of the Treasury (301/396-1924).

EXHIBIT A

City of Baltimore
Bond Authorization and Projects Awaiting Permanent Financing
Construction Financing Provided by Advance of City Funds

A. 10th Urban Renewal Ordinance $3,310,00

(1) Lexington Market Arcade $3,310,00

This project, an encouragement to private owners and merchants in the old Howard Street retail district, is owned by the City and leased to a non-profit corporation supported by the City. Stalls in the arcade are leased to a number of small for-profit vendors. Construction of the arcade began summer, 1981.

B. 2nd Industrial Financing Ordinance $5,040,000

These moneys have been used to make loans (or to guarantee loans) to various for-profit entities otherwise unable to obtain sufficient financing for their projects.

(1) Shake and Bake, $4,700,000, construction loans approved July 1, 1981 and October 6, 1982. This is a minority-sponsored neighborhood recreation center in west Baltimore. The sponsors were unable to find a lender for the project, and therefore the City made the construction loan.

(2) Norman Holt Florist, $110,000, construction loan approved April 19, 1981.
This small business venture was also assisted with a loan guarantee (see 4th Industrial Ordinance, below).

(3) Rockland Industries, $230,000, approved March, 1982. This textiles fabricator was forced to relocate from its Falls Road plant. This construction loan was part of a financing package (including an IDB and a loan guarantee by the City) which helped the company relocate its 200+ employees to a plant site within the City (see 4th Industrial Ordinance, below).

C. 3rd Industrial Financing Ordinance $1,095,000

(1) Belvedere Hotel, $1,000,000, approved July 15, 1981. This grand old building in the recently revitalized Mt. Vernon area (arts and culture center of the City) has undergone historic renovation and has been re-converted from apartment to hotel use (see also 4th Industrial Ordinance, below).

(2) Camp Manufacturing, $95,000, approved May 13, 1981. This company fabricates various school supplies. It used the City loan (along with an IDB) to expand its production facilities and employment (see also 4th Industrial Ordinance, below).

D. 4th Industrial Financing Ordinance $3,000,000

(1) Camp Manufacturing, $845,000, (see above)
(2) Belvedere Hotel, $2,000,000, (see above)
(3) Loan Guarantees $155,000

In addition to making direct loans, the City has found it necessary in some cases to guarantee all or a portion of loans made by banks or other parties. In such cases, the City normally places in escrow a 5% portion of the amount guaranteed. The guarantees in this instance are for loans made to Norman Holt Florist and Rockland Industries (both described above).

E. 1st Housing Development Ordinance $9,620,000

Moneys have been advanced to make construction loans or to guarantee loans made to developers of multi-family projects, in most instances to provide housing for low and moderate income families, and to undertake major renovations that have proven to be catalysts to neighborhood revitalization.

(1) Edmondale Apartments, $4,270,000, approved September 29, 1981 and September 29, 1982. Two hundred sixty-two low and moderate income units were rehabilitated with the City's construction loan. The project was delayed and the loan amount increased because of problems with contractor performance (see also 2nd Housing Ordinance, below).

(2) Battery Place, $5,350,000, approved August, 1981. Formerly the abandoned Southern High School, an eyesore inhibiting private investment in a residential neighborhood to the south of the Inner Harbor area. Conversion to market-rate apartments was financed originally with a guarantee of developer's construction loan. Developer was subsequently unable to pay on his loan, which required City performance under the guarantee.

F. 2nd Housing Development Ordinance $1,305,000

(1) Edmondale Apartments, $1,305,000, (described above)

G. 2nd Residential Financing Ordinance $140,000

(1) Pimlico Center-The International, $140,000, approved October 1978 thorugh March 1980. This former Holiday Inn in a blighted area in the northwest part of Baltimore, has been renovated and adapted in part to residential units.

H. 1st Commerical Financing Ordinance $3,488,000

4th Commerical Rehabilitation Ordinance $1,250,000

Construction financing has been advanced by the City under its Commercial REAL Loan program to make improvement loans to small businesses, many of them start-up operations, and thereby bring about physical improvements in neighborhood commercial areas.

The attached list shows loans closed 1980 through 1983.

Address	User	Use	Amount	Closing Date
1829-31 Pennsylvania Ave.	RUBIN & GREENBAUM	retail	58000	3/28/80
4330-32;4400-04 York Rd.	KNEAVEL, William S.	retail	26860	2/26/82
3313 Greenmount Ave.	LEE, HYC, I: SUN HO CORP	restaurant	105000	1/4/80
3220 Greenmount Ave.	ADLER, Ira, Lucille	retail	67000	1/15/80
911 W. 36th Street	BREIGHNER, Bernard	retail	150000	9/19/80
2911 Greenmount Ave.	VACINO, Paul, Marcia	retail	33000	9/17/80
3431 Greenmount Ave.	BOWDEN, Susan D.	retail	17000	9/3/80
1603-05 St. Paul St.	LAMBERG, Standford, Lynne	offices	100000	2/27/81
100 E. 23rd Street	WOLFF, Harold, Ellen	offices	50000	8/27/81
153 N. Patterson Park Ave.	BEAVEN, Brian P.	restaurant	20000	2/26/82
210 E. Centre Street	JENKINS, Courntey; D.A.C.	health club	150000	2/11/82
5 Lloyd Street	MANDELL, JH, LL: BLUMBERG, KD	offices	25000	1/28/82
3203-8 Greenmount Ave.	MILLER REALTY: PRINCESS SHOPS	retail	75000	12/23/81
1020 S. Charles St.	HALLOWELL, John, Mary	retail/apts	50000	4/1/82
4341-45 York Road	INNER HARBOR LUMBER NORTH	ret/lmbr.	50000	2/16/82
4341-45 York Road	TREMPER, Theodore, Mary	retail	50000	2/26/82
Broadway Market	INT'L GROCERY; Mandatos	retail	27250	3/11/82
1708-20 Gorsuch Ave.	APPLEFELD, Michael	day care ctr.	65000	3/8/82
1413 S. Haven Street	SHAUGHNESSY, John, Mary	warehouse	60000	4/8/82
328 N. Charles St.	MCGINN, George	tavern	20000	7/26/82
809-18 W. 36th Street	SINGH, Jogendra	offices	25000	4/12/82
1633 E. Baltimore St.	WILLIAMS, Harry, Lorna	retail/home	55000	6/23/82
1600 S. Hanover St.	RASHED, Lotfy Sayed	vet office	45000	6/12/82
14 E. Preston St.	FULTON, James R.	office/apts	64800	7/1/82
4519 York Rd.	DRURY, JE: JED AUTOMOTIVE	retail	50000	6/29/82
1101 S. Howard St.	PRINCIPIO, Lou	tavern	60000	8/11/82
4500 York Rd.	WYBORSKI, J T, D	offices	26000	3/16/83
1443 Gorsuch Ave.	DURANS, Cliff: Research Assoc.	offices	48000	7/1/82
2127-29 W. Pratt St.	RISLEY, Bryan, Dorothy	mfg/retail	55000	8/18/82
4707-11 Liberty Hghts Ave.	NAM, Ki Young, Chi Dae	restaurant	45000	9/21/82
113 W. Franklin St.	SHANER, Thomas, Carol	offices	60000	12/23/82
825 E. Baltimore St.	LARKINS, Hayes, Eudora	office/apts	84000	11/18/82
200-02 W. Pratt Street	KATZENSTEIN, Stanley	retail	131500	12/21/82
3100 Elm Avenue	EDMEISTER, S; PRICE, S	studio/home	81000	3/24/83
828 E. Baltimore St.	WEBB, DALE, Synthia	offices	40000	6/16/83
4721-31 Liberty Hghts. Ave.	BINSKY, Ruth Wise	retail	118400	3/10/83
4625-27 Liberty Hghts. Ave.	CALVIN, Zisy Sondra	retail	12000	3/21/83
2301 N. Charles St.	BLG.CNGRES.EXCHNG.-Gus Robbins	offices	27000	5/22/82
1001 Hillen Street	LABOO, Roosevelt	offices	33445	8/26/83
2215 W. Forest Pk. Ave.	HUNT, PATRICIA-Dckyvl. Nursery	daycenter	12000	8/3/83

Address	User	Use	Amount	Closing Date
916 Light Street	SEWARD, Melvin, Delores	retail	75000	5/26/83
Lot 3, Holabird Ind Pk	COHUTTA ASSOC.	office/whse	61500	5/10/83
5217 York Road	HERRON, James & Barbara	offices	80000	7/14/83
400 E. Pratt Street	ORENDORFF, Gree. & POMPA, Vinct	restaurant	25000	10/28/83
824-26 E. Baltimore St.	BONNER, Wm., DAVIDSON, James	offices	180000	12/16/83
832 E. Baltimore St.	FEIT, BEN & SHIRL, IRV & RENEE	offices	70000	9/12/83
811 E. Baltimore St.	MEDAGLIA, Corneleus P.	office/rest	35000	7/25/80
4100 Pennington Ave.	GILDEN, Louis	retail	10000	10/18/83
4606 Garrison Blvd.	SCHULMAN, JALOWSKY	retail	21700	12/14/83
1737 Pennsylvania Ave.	FRANKLIN, Allan	retail	25200	10/21/83
2200 N. Howard St.	EZRINE, Chrl., BECKER, Larry	servicing	30000	11/17/83
515 W. Coldspring Lane	LEEB, Melvyn & Leslie	manuftrng	44000	12/28/83
805-07 E. Fayette St.	CRAEMER, Albert	restaurant	240000	2/26/80
422-24 W. Redwood St.	SILVERMAN, B, M; RAUSCHWALBE	retail/office	150000	3/14/80
1114-20 S. Charles St.	BROWN, SM, AR, A, P	retail	85000	10/6/80
814-20 N. Chester Street	NORTHEASTERN PLUMBING & HEAT	offices	60000	10/22/80
629 N. Duncan Street	CHERRY, Jack W.	retail	35300	1/19/81
823 W. Baltimore St.	SCHAEFER, RC, VA; Apollo	offices	87500	5/12/81
813 E. Baltimore St.	JOHNSON, Edward M.	offices	200000	4/10/81
3801 Fleet Street	KREBS FURNITURE; KREBS, LW, M	retail	50000	1/14/81
1401-09 S. Haven St.	WALHAUPTER, John	warehouse	32000	4/1/82
1620 Shakespeare St.	NORTON, Charles, Darcy	retail	63500	3/27/81
8 N. Howard St.	SANDLER, Bernard	hotel	200000	5/1/81
326 Park Avenue	FLORENDO, G, R	restaurant	68000	10/6/81
901-05 Fawn Street	SABATINO'S, INC.	restaurant	60000	7/27/81
322 N. Charles St.	SHAH, Arum, Maria	restaurant	110000	7/28/81
7 E. Franklin St.	ELLIS, David	offices	36000	10/21/81
2912 Oliver St.	OLIVER STREET PLAZA LTD.	retail	100000	12/12/81
1601-07 St. Paul Street	SEARS, JE; SMITH, BB	offices	55000	12/4/81
801 N. Charles St.	CHENG & ASSOCIATES	restaurant	100000	1/22/82
1309-11 N. Charles St.	BLOOM, Morris	tavern	42000	12/15/81
506-08 Pennsylvania Ave.	PLOTKIN, Gerald, Delores	retail	33600	7/6/80
1523 W. Baltimore St.	MINION, J, C; NEW IDEAS	retail/office	116400	1/18/80
204-08 W. Pratt St.	GOODMAN, Ellis	restaurant	250000	7/24/80
600 Washington Blvd.	STICK, Gordon, Jennifer	office/apts	97600	12/5/80
1036-40 Patapsco St.	STREUVER, FSS, NS MB	retail	30000	1/7/81
1210-12 Bayard St.	KORZEC, George, Ameliese	retail	55000	11/17/80
835 W. Lombard St.	MEKULSKI; SCHIAVONE	retail/office	50000	2/17/81
1399 Ramsey St.	SHOWALTER, M; MUELLER, W, F	mfg/retail	8000	6/16/81

Address	User	Use	Amount	Closing Date
29-31 W. North Ave.	PAK, Hou-oral, Kyuryon	offices	70000	10/15/81
1831 Pennsylvania Ave.	RUBIN, STONE GREENBAUM	retail	58000	3/28/80
3601 Park Hgts. Ave.	ROBINSON, Clifford, Pettis	retail	60000	7/13/80
1603-07 Sulgrave Ave.	KLEIN, Stanly, Esther	retail	24350	6/16/80
3401½ Clifton Ave.	FELDMAN, Samuel	retail	37100	10/29/80
5726 Falls Rd.	LEEB, Melvyn, Leslie	mfg/office	17000	10/6/81
1600-02 W. Baltimore St.	FINCHAM, Victor	tavern	16600	10/6/81
4713-35 Gwynn Oak Ave.	FELDMAN, Samuel, Fannie	retail	32000	1/22/82
5460 Park Hgts. Ave.	KWON, Joug, Me Hwa	retail	50000	3/27/81

EXHIBIT B

PROPOSED NEW SUBSECTION (a)(4) OF SECTION 166 OF TECHNICAL CORRECTIONS ACT OF 1985

(S.814)

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(4) by adding a new subsection (4) as follows:

(4) CERTAIN GENERAL OBLIGATION BONDS ISSUED BY MAYOR AND CITY COUNCIL OF BALITMORE. No obligations of the Mayor and City Council of Baltimore issued after June 30, 1985 which are not industrial development bonds (within the meaning of subsection (b)(2)) shall be treated as private loan bonds on account of the use of a portion of the proceeds of such obligations to finance or refinance temporary advances made by the City of Baltimore in connection with loans to persons who are not exempt persons (within the meaning of subsection (b)(3) if (i) the portion of the proceeds of such obligations so used is attributable to debt approved by voter referendum on or before November 2, 1982, (ii) the loans to such non-exempt persons were approved by the Board of Estimates of the City of Baltimore on or before October 19, 1983, and (iii) the aggregate amount of such temporary advances financed or refinanced by such obligations does not exceed $27,000,000.

WRITTEN STATEMENT OF SUSAN PATRICIA FRANK, ESQUIRE

Written statement of Susan Patricia Frank, Esquire, of Sanders, Schnabel & Brandenburg, P.C., Washington, D.C., for the printed record of the June 5, 1985 hearing of the Senate Committee on Finance on S.814, The Technical Corrections Act of 1985.

This written statement contains comments on the proposed amendment to Section 408(d)(3) of the Internal Revenue Code ("Code") by Section 152(a)(5)(C) of S.814 and its possible implications with respect to the eligibility for rollover treatment of a distribution to a surviving spouse from a deceased spouse's individual retirement account or individual retirement annuity ("IRA"). For the reasons discussed below, it is recommended that the proposed amendment to Section 408(d)(3) of the Code be amended to make it clear that it is not intended to deny rollover treatment by the surviving spouse of a deceased IRA owner.

Section 152(a)(5)(C) of S.814 amends Section 408(d)(3) of the Code (relating to rollover contributions) as follows:

> "(E) DENIAL OF ROLLOVER TREATMENT FOR REQUIRED DISTRIBUTIONS - This subparagraph shall not apply to any amount to the extent such amount is required to be distributed under [Section 408](a)(6) or (b)(3) [relating to distributions from individual retirement accounts and individual retirement annuities]."

The proposed amendment to Section 408(d)(3) creates uncertainty as to whether a surviving spouse will be permitted to rollover his/her interest in a deceased spouse's IRA into his/her own IRA. This uncertainty occurs because under the proposed amendment, rollover treatment would be denied to any amount to the extent such amount is required to be distributed under Section 408(a)(6) or 408(b)(3). Since Section 408(a)(6) and Section 408(b)(3) provide that rules similar to the distribution rules of Section 401(a)(9) are to be applied to IRA distributions, the following discussion will center on the potential conflict between the distribution rules set forth in Section 401(a)(9) and the proposed amendment to Section 408(d)(3).

I. Prior to Proposed Amendment to Section 408(d)(3) -

It should be noted that prior to the proposed amendment to Section 408(d)(3) of the Code by Section 152(a)(5)(C) of S.814, it would appear that there was no impediment to a surviving spouse rolling over his/her interest in a deceased spouse's IRA into his/her own IRA, for the following reasons:

(1) Under Section 401(a)(9)(B)(i) (relating to distributions which began prior to the owner's death), the only requirement is that the interest remaining in the IRA at the owner's death be distributed at least as rapidly as under the method of distribution in effect as of the date of the owner's death. Therefore, if the surviving spouse elects to have his/her entire interest in the IRA distributed to him/her on or before the date on which the next distribution would have been made to the owner, the requirements of Section 401(a)(9)(B)(i) would be satisfied. The spouse could then utilize Section 408(d)(3)(C) to rollover his/her distribution into his/her own IRA.

(2) Under Section 401(a)(9)(B)(ii) (relating to distributions which did not begin prior to the owner's death), a beneficiary's entire interest in the IRA is required to be distributed within 5 years of the owner's death. If the owner's spouse elects to rollover his/her interest into his/her own IRA,

within the 5 year period, then the provisions of Section 401(a)(9)(B)(iv) (rules relating to distributions to a surviving spouse from a deceased spouse's IRA or qualified plan if the remaining interest is not distributed within 5 years of the owner's death) would be inapplicable since those rules relate to distributions payable under Section 401(a)(9)(B)(iii) and not to distributions payable under Section 401(a)(9)(B)(ii).

II. Possible Effect of Proposed Amendment to Section 408(d)(3) -

Although perhaps not the intended effect of the proposed amendment to Section 408(d)(3), the proposed amendment could be read as denying rollover treatment to an attempted rollover by the surviving spouse if the date on which distributions to the surviving spouse were to commence under the surviving spouse's IRA was later than the date on which such distributions would have been required to commence to the spouse under the deceased spouse's IRA. In the aforesaid situation, the practical effect of the rollover by the surviving spouse at any given time would be to reduce the amount required to be distributed under Section 401(a)(9) and therefore under Section 408(a)(6).

This problem can be illustrated by the following examples in which it will be assumed that the surviving spouse is younger than the deceased spouse ("owner").

(1) If the owner of the IRA had commenced distributions under Section 401(a)(9)(A)(ii) prior to his/her death and the surviving spouse does not roll over the balance in the owner's IRA into his/her own IRA, then under Section 401(a)(9)(B)(i) the remaining balance in the IRA would be required to be

distributed to the surviving spouse at least as rapidly as under the method of distribution being used as of the date of the owner's death. On the other hand, if the surviving spouse is permitted to roll over the remaining balance into his or her own IRA and the surviving spouse was, for example, age 60 at the owner's death, the surviving spouse would not be required to commence distributions from his or her own IRA for over 10 years after the death of the owner.

(2) If the owner of the IRA had not commenced distributions under Section 401(a)(9)(A)(ii) prior to his/her death, then under Section 401(a)(9)(B) the surviving spouse would be required to receive the entire balance of the IRA within 5 years after the owner's death or in the alternative to commence distributions by the later to occur of one year after the owner's death or the date on which the owner would have attained age 70 1/2. On the other hand, if surviving spouse is permitted to roll over the remaining balance into his or her own IRA, the surviving spouse would not be required to commence distributions until April 1 of the calendar year following the calendar year in which the surviving spouse attained age 70 1/2 rather than on the date on which the owner would have attained age 70 1/2.

As illustrated in the above example, a rollover by the surviving spouse may have the effect of reducing the amount, which but for the rollover, would be required to be distributed under Section 408(a)(6) in a given year. Consequently, if the proposed amendment to Section 408(d)(3) is read literally, it could be argued that a distribution to the surviving spouse who is younger than the deceased spouse would not be eligible for rollover treatment under the proposed amendment to Section 408(d)(3).

It should also be noted that the same impediment does not appear to exist if the rollover is to be made from a qualified plan to a surviving spouse's IRA. If the same problem did exist, there would be no point to the provisions of Section 402(a)(7) which specifically provides rules relating to rollovers in the case of a surviving spouse. Additionally, the "Description of the Technical Corrections Act of 1985" prepared by the staff of the Joint Committee on Taxation, provides at page 93 that:

> "The bill provides that the rules relating to rollovers in the case of a surviving spouse of an employee who received distributions after the employee's death apply to permit rollovers to an IRA but not to another qualified plan...."

Since it is the intention of the distribution rules that distributions from qualified plans and from IRAs be treated consistently (for example, the incidental death benefit rule is to be applied to IRA distributions as well as distributions from qualified plans), it is recommended that the proposed amendment to Section 408(d)(3) by Section 152(a)(5)(C) of S.814 be amended to make it clear that the proposed amendment is not intended to deny rollover treatment by a surviving spouse of deceased IRA owner.

LENTZ, EVANS AND KING P. C.
ATTORNEYS AT LAW

HOVER T. LENTZ
BRUCE L. EVANS
FRANCIS P. KING
WILLIAM W. SCHLEY
ROBERT A. WHERRY, JR.
BRUCE R. MUIR
RICHARD B. ROBINSON
KAREN McMURRY
RICHARD M. HOPPER
DIANE R. LARSEN
JOHN M. MOORE

2900 LINCOLN CENTER BUILDING
1660 LINCOLN STREET
DENVER, COLORADO 80264
AREA CODE 303 861-4154

May 28, 1985

STATEMENT OF LENTZ, EVANS AND KING P.C., ON BEHALF OF SILCO FUELS, INC., a Colorado Corporation

SENATE FINANCE COMMITTEE HEARING CONCERNING PROVISIONS IN THE TECHNICAL CORRECTIONS ACT OF 1985

SB 814

CONCERNING THAT PORTION OF THE BILL ESTABLISHING AN EFFECTIVE DATE FOR SECTION 312(n)(8) AS ADOPTED IN THE DEFICIT REDUCTION ACT OF 1984 (PL 98-369)

SUMMARY OF PRINCIPAL POINTS

The Deficit Reduction Act of 1984, enacting new Section 312(n)(8) of the Internal Revenue Code of 1954, as amended ("IRC"), changed the rules relating to the computation of a corporation's accumulated earnings and profits after a stock redemption. HR 4170, the House version of the Deficit Reduction Act of 1984, did not contain this provision. The genesis of the provision was the Senate Finance Committee Report approved by the Finance Committee on March 21, 1984.[1] The proposed effective date for this new provision was established by Section 47(d)(1)(A) of the Senate Bill, which provided that:

> "Except as provided in this paragraph, the amendments made by subsection (a) shall apply to amounts paid or incurred in, or distributions or redemptions occurring in, taxable years beginning after the date of the enactment of this Act."[2]

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[1] The specific provision involved was contained in Title 1, Sub-Title D, Part 3, Section 47(a)(1) (located on page S-58 of the BNA Special Supplement, DER #67), April 6, 1984, Vol. 2.

[2] Contained on Page S-60 BNA, Vol. 2

The Senate Finance Committee explanation[3] provided that:

> "This provision is applicable with respect to the effect on earnings and profits of distribution in taxable years beginning after the date of the enactment."

The Conference Committee Report to accompany HR 4170[4] contains the Senate Finance Committee redemption provision at pages 93 and 94. Subparagraph "(e)" of §61 contains effective dates for paragraphs (1), (2), (3), (4), (5), and (7) of new IRC §312(n), but, without explanation, failed to contain an effective date for paragraph (8), the redemption provision. However, the narrative portion of the Conference Committee Report dealing with redemption provision, contained on page 838 of the Conference Committee Report, states:

> "The Conference agreement generally follows the Senate amendment with several modifications."

Because the redemption provision came from the Senate Finance Committee Report, the Conference Committee Report adopted the Senate substantive provision unaltered, and because the Conference Committee Report indicated it generally followed the Senate Report, Silco presumed that the effective date for the redemption provision would be the same as contained in the Senate Report, i.e., effective for taxable years beginning after the date of enactment.

To correct the apparent oversight in the Conference Committee Report which failed to include a specific effective date for the new redemption provision, IRC §312(n)(8), the Technical Corrections Act of 1985 (HR 1800 and Senate Bill 814) contains in §104(e) a provision establishing an effective date of July 18, 1984. Because of the history of the redemption provision, Silco believes a more appropriate effective date would be one effective for taxable years beginning after July 18, 1984.

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[3] Contained on Page S-59 BNA, Vol. 1, BNA Special Supplement, DER #66, April 5, 1984.

[4] §61(a)(1), page 92 of the Government Printing Office Report.

GENERAL DISCUSSION

On December 12, 1984, Silco Fuels, Inc. ("Silco"), a corporation taxable under Subchapter S of the Internal Revenue Code of 1954, as amended ("IRC"), redeemed the shares of one of its principal shareholders for an aggregate consideration of One Million Dollars. Immediately before the redemption, Silco had earnings and profits slightly in excess of One Million Dollars.

Silco has been in the diesel oil distributing and real estate businesses. It is Silco's intention to terminate its diesel oil distribution business and retain its real estate business. However, from a practical tax viewpoint, it cannot remain as a qualified Subchapter S corporation if it engages only in the real estate business receiving "passive income" and has accumulated earnings and profits while it was a corporation taxable under IRC Subchapter C.

Under the law, prior to the Deficit Reduction Act of 1984, earnings and profits were reduced on a distribution by a corporation in a redemption of shares of its own stock in an amount equal to the excess of the amount of the distribution over the amount "properly chargeable" to the corporation's capital account. In applying this rule, some cases held, and the Internal Revenue Service eventually ruled, that the amount properly chargeable to a corporation's capital account was an amount equal to the par value of its stock plus the amount, if any, of paid-in surplus. See e.g., Jarvis v. Comm., 43 BTA 439, aff'd 123 F2d 742 (4th Cir. 1941) and Revenue Ruling 79-376, 179-2 CB 133.

Section 312(n)(8) changed the prior law relating to the computation of earnings and profits of a corporation. New paragraph (8) deals with redemptions and provides that if a corporation distributes an amount in a redemption, the part of such redemption which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable charge of the earnings and profits of such corporation attributable to the stock redeemed.

The effect of the change to Silco's earnings and profits under prior law would be approximately One Million Dollars as opposed to approximately one-third of this amount under the Deficit Reduction Act of 1984. Accordingly, without substantial adverse tax consequences, Silco cannot terminate its diesel oil distributing operation and remain a Subchapter S corporation.

The Senate Committee Report, in discussing the provision relating to redemptions, stated:

> "This provision is applicable with respect to the effect on earnings and profits of distributions in taxable years beginning after the date of enactment."

The Conference Committee Report stated that the Conference agreement is generally the same as the Senate amendment and made no reference to the effective date. The Bill, as enacted, stated no effective date for the provision of §312(n)(8), and, therefore, it was deemed to be the date of enactment, July 18, 1984. The Technical Corrections Act of 1985, introduced March 28, 1985, contains revisions to the Deficit Reduction Act of 1984 which are intended to clarify and conform various provisions adopted by the original legislation. One such clarification, contained in §104(e) of the Act, is to provide a specific effective date for §312(n)(8). This proposed provision states that IRC §312(n)(8) applies to redemption distributions after July 18, 1984. It is respectfully submitted that such amendment should provide that it applies only to distributions in tax years beginning after July 18, 1984, as provided in the original Senate Committee Report, and not for transactions occurring after the effective date of the Deficit Reduction Act of 1984.

The Silco redemption giving rise to this letter was in the negotiating stage in excess of eight months prior to the adoption of the Deficit Reduction Act of 1984. Delay in finalizing the matter occurred, in substantial part, because of the redeemed shareholder's health. At the time the transaction was effected, it was fully expected that the "oversight" of the effective date would be corrected to conform with the Senate Committee's recommendation.

While it is not possible to represent that the transaction would not have been effected under any condition, taxpayers, including Silco, should, based on the history of this provision, be entitled to at least complete their fiscal year under prior law. Accordingly, it is respectfully requested that the Committee amend Section 104(e) of the Technical Corrections Act bill as submitted, to provide that:

"The provisions of Paragraph 8 of Section 312(n) of such Code shall apply to redemptions made in taxable years beginning after July 18, 1984."

We appreciate the Committee's consideration of our request, and we urge you to act favorably on this proposed amendment.

Sincerely,

LENTZ, EVANS AND KING P.C.

By: Robert A. Wherry, Jr.

Robert A. Wherry, Jr.

RAW/pjk

LAW OFFICES
SILVERSTEIN AND MULLENS
1776 K STREET, NORTHWEST
WASHINGTON, D.C. 20006
(202) 452-7900

LEONARD L SILVERSTEIN
RICHARD A MULLENS
GERALD H SHERMAN
NICHOLAS A TOMASULO
ROBERT E FALB
JERRY J McCOY
ADELBERT L SUWALSKY JR
STUART M LEWIS
RONALD D ABRAMSON
LYNN R PEARLE
JOHN P WARNER
ROBERT E LILES II
DARDYL R TIBANA
HARRISON B McCAWLEY
JAVED A KHORRAM

DONALD B REYNOLDS JR
CHARLES E TAYLOR
CONRAD J MATHISON
JOSEPH J WESTWATER JR
PATRICIA R LESSER
PATRICK G DOOHER
DIANE J FUCHS
WILLIAM C WICKER
DEBORAH M BEERS
JAMES F MILLER
JOHN FREEMAN BLAKE
SAMUEL M MARUCA
ELIZABETH D DEPRIEST
JOHN F LEFEVERE*

*NOT ADMITTED IN D C

EDWARD L MERRIGAN
COUNSEL

CABLE "SIMUL WSH"
TELEX 64420
TELECOPIER (202) 452-7980

WRITER'S DIRECT DIAL NUMBER

(202) 452-7926

June 7, 1985

HAND DELIVERED

Betty Scott-Boom
Senate Finance Committee
Room 219, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Scott-Boom:

Enclosed is the original and six copies of our comments to Section 112(e)(1)(B) (regarding the retroactive amendment of the Gas Guzzler tax) of the Technical Corrections Act of 1985.

Sincerely,

SILVERSTEIN AND MULLENS

James F. Miller

JFM/cca

MEMORANDUM

SECTION 112(e)(1)(B) OF THE TECHNICAL CORRECTIONS ACT OF 1985 (RETROACTIVE GAS GUZZLER TAX AMENDMENT)

This memorandum urges that the 8-year retroactive effect of Section 112(e)(1)(B) of the Technical Corrections Act of 1985 (the "Act") be deleted and that such provision (the Gas Guzzler Tax Amendment) only be applied prospectively from the date of enactment of the Act.

Rolls-Royce Motors Inc. ("Motors"), a domestic corporation with approximately 100 employees and headquartered in Lyndhurst, New Jersey, imports Rolls-Royce motor vehicles (approximately 1,000 in 1984) from its U.K. affiliated corporation (Rolls-Royce Motors Ltd.) which it sells to its franchised U.S. dealerships.

From 1980 through early 1985, Motors paid the "Gas Guzzler" tax imposed by Section 4064 of the Internal Revenue Code of 1954, as amended (the "Code"), pending the Treasury Department's consideration of Motors' applications (filed in 1979 and 1981) for use of "an alternative rate schedule" as a "small manufacturer." Both applications were denied on the ground that the use of Rolls-Royce vehicles in the United States does not serve "an important public policy", a requirement entirely formulated by the Treasury without any evident legislative support under Section 138.4064-1(d)(ii) of the Temporary Regulations.1/

1/ The legislative history to the Gas Guzzler tax strongly supports the primary assertion made in Motors' applications that the "public policy" requirement in the Temporary Regulations constitutes an improper gloss on the small manufacturer provisions in Section 4064(d). The Conference Report (H. Rep. No. 95-1773, 95th Cong., 2nd Sess.) to the Energy Tax Act of 1978 (P.L. 95-618) clearly states that the small manufacturer provisions of the Gas Guzzler tax (Section 201 of the Energy Tax Act) are "generally patterned" on the small manufacturer provisions of the Energy Policy and

(Footnote continued on next page)

Shortly after receiving the denial of its second application for use of an alternative rate schedule in November 1984, Motors shifted the focus of its argument for relief from the Gas Guzzler tax to the fact that almost all Rolls-Royce models which it imports and sells have a gross vehicle weight rating greater than 6,000 pounds.[2] Because Section 4064(b)(1)(A) defines the word "automobile" as a

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(Footnote continued from previous page)
Conservation Act of 1975 ("EPCA") (P.L. 94-163). EPCA, in turn, provides alternative rate schedules from the Corporate Average Fuel Economy ("CAFE") standards for small manufacturers, but does not condition such relief on meeting a public policy requirement. Motors, in accordance with EPCA, has repeatedly been granted alternate rate schedules with substantially less onerous fuel efficiency requirements. See, e.g., 49 C.F.R. Sec. 531.5(b)(2). Nowhere in the legislative background of the Gas Guzzler tax does there appear any articulation of the reasons underlying the enunciation of a "public policy" constraint upon grant of the "small manufacturer" alternate rate schedule.

2/ Gross vehicle weight rating is defined to mean "the value specified by the manufacturer as the loaded weight of a single vehicle." 49 C.F.R. §523.2. The "loaded weight of a single vehicle" includes the sum of "curb weight" (i.e., the "weight of a motor vehicle with standard equipment including the maximum capacity of fuel, oil, and coolant, and if so equipped, air conditioning and additional weight optional engine"), "accessory weight" (i.e., the "combined weight (in excess of those standard items which may be replaced) of automatic transmission, power steering, power brakes, power windows, power seats, radio, and heater, to the extent that these items are available as factory-installed equipment (whether installed or not))", "vehicle capacity weight" (i.e., the "rated cargo and luggage load plus 150 pounds times the vehicle's designated seating capacity"), and "productions options weight" (i.e., the "combined weight of those installed regular production options weighting over 5 pounds in excess of those standards items which they replace, not previously considered in curb weight or accessory weight, including heavy duty brakes, ride levelers, roof rack, heavy duty battery, and special trim"). See 49 C.F.R. §571.110

"4-wheeled vehicle propelled by fuel * * * (i) which is manufactured primarily for use on public streets, roads, and highways * * * and (ii) which is rated at 6,000 pounds gross vehicle weight or less," Motors filed refund claims on March 18, 1985, based on the contention that none of the Rolls-Royce models with gross vehicle weight ratings greater than 6,000 pounds constitutes an "automobile" for purposes of the tax and on the fact that the tax was not passed through to dealers or consumers.[1/]

Section 112(e)(1)(B) of the Technical Corrections Act of 1985 (H.R. 1800 and S. 814, introduced on March 28, 1985), would change the definition of the word "automobile" in Section 4064(b)(1)(A) by striking out the term "gross vehicle weight" and inserting in lieu thereof the term "unloaded gross vehicle weight." Since the Rolls-Royce vehicles in question appear to have an "unloaded gross vehicle weight" less than 6,000 pounds, they will be subject to the tax imposed by §4064(b)(1)(A). The proposed amendment is retroactive to 1978 and, in view of the Treasury Department's denial of its applications for use of the alternative rate schedule, would make Motors fully liable for all taxes paid from 1980 through early 1985.

Our reasons in support of applying Section 112(e)(1)(B) prospecively only are as follows:

3/ Motors' refund claims were for Gas Guzzler taxes (approximately $5 million) paid from the first quarter of 1982 through the fourth quarter of 1984. Its 1980 and 1981 tax years were closed due to the running of the three year statute of limitations for refund claims.

Retroactive Application Of The Gas Guzzler Tax To Rolls-Royce Is At Variance With Traditional Congressional Restraint With Regard to Retroactive Tax Legislation That Adversely Affects Taxpayer Interests.

Whether or not Congress would have rejected a clear proposal which expressly excluded Rolls-Royce vehicles from the Gas Guzzler tax is not at issue in this memorandum, since Congress in fact adopted a definition of "automobile" which effectively excluded such vehicles from the tax. It did so only after closely considering and rejecting one other alternative: a definition which would have empowered the Secretary of Treasury to tax certain passenger automobiles with gross vehicle weight ratings in excess of 6,000 pounds, such as, presumably, the Rolls-Royce vehicles currently excluded from the tax. Given the absence of any discussion to the contrary in the legislative history, Motors had every reason to believe that Congress intended to exclude vehicles with gross vehicle weight ratings in excess of 6,000 pounds from the tax and to rely on the clear language of the statute when filing its refund claims. Such reliance appeared not to have been misplaced, moreover, in view of the fact that Congress had never attempted to revise the statute to include vehicles such as Rolls-Royce model vehicles in the eight years since the statute had been adopted. Thus, the proposed "clarification"[4] should not be applied retroactively. To do so would be both unfair and at variance with traditional Congressional restraint with regard to retroactive tax legislation that adversely affects taxpayer interests and expectations.

A. Development of the Gas Guzzler Tax

(1) On May 16, 1977, then Secretary of Treasury W. Michael Blumenthal testified before the House Ways and Means Committee respecting the Carter Administration's proposed "Fuel Inefficiency Tax", the precursor to the Gas Guzzler tax. In the description of the tax attached to Secretary Blumenthal's prepared testimony, it was stated that for model year 1978, the tax would apply to "all passenger automobiles",

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4/ See the Joint Committee on Taxation Description of the Technical Corrections Act of 1985 at page 52.

generally defined as "4-wheeled vehicles * * * rated at 6,000 lbs. gross vehicle weight or less."[5] For 1979 and later model years, the tax would apply to "4-wheeled vehicles rated at more than 6,000 lbs. gross vehicle weight but less than 10,000 lbs. gross vehicle weight if the Secretary of Transportation determines that (i) it is feasible to establish fuel economy standards for such vehicles and that such standards will result in significant energy conservation, or, (ii) if such vehicles are of a type that the Secretary determines is substantially used for the same purpose as lighter vehicles."[6] The proposed inclusion of 4-wheeled vehicles rated at more than 6,000 lbs. gross vehicle weight but less than 10,000 lbs. gross vehicle weight mirrored the definition of "automobile" set forth in the Energy Policy and Conservation Act ("EPCA") (P.L. 94-163).

(2) On July 13, 1977, the Committee issued its Report on the Energy Tax Act of 1977 (H.R. 6831). In this bill, which had changed the "Fuel Inefficiency Tax" to the Gas Guzzler Tax, the Ways and Means Committee Report significantly reveals that, although the Committee was aware of the EPCA 6,000-to-10,000 pounds alternative definition of "automobile", it nevertheless chose to apply the Gas Guzzler tax to automobile vehicles having a gross vehicle weight rating *of no more than 6,000 pounds*.[7] This interpretation was confirmed by the Committee in a document[8] rejecting the Carter Administration proposal giving discretionary authority to the Secretary to tax vehicles with gross vehicle weight ratings between 6,000 and 10,000 pounds. In this

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5/ *See* Ways and Means Committee Print on Tax Aspects of the President's Energy Program Hearings (95-21) at pages 22-23.

6/ *Id*.

7/ H. Rep. No. 95-496 (part III), 95th Cong. 1st Sess. at pages 47, 50.

8/ Ways and Means Committee Summary and Section By Section Description of Title II of the Energy Tax Act of 1977 (H.R. 6831) at page 38.

respect, the Committee stated:

> "a gas guzzler tax would apply to the sale or initial lease by the manufacturer (or importer) of automobiles having a gross vehicle weight of no more than 6,000 pounds which fall below certain fuel efficiency standards established by the Committee." (emphasis supplied).

Simultaneously, the Secretary of Transportation in regulations under EPCA recognized that some vehicles commonly considered as automobiles in fact have gross vehicle weight ratings in excess of 6,000 pounds: Section 523.3(b) of 49 C.F.R. provides, in pertinent part, that

> "[t]he following vehicles rated at more than 6,000 pounds and less than 10,000 pounds gross vehicle weight are determined to be automobiles:
> (1) Vehicles which would satisfy the criteria in Sec. 523.4 (relating to passenger automobiles) but for their gross vehicle weight ratings."

Section 523.4 of 49 C.F.R., in turn, defines "passenger automobile" as "any automobile (other than an automobile capable of off-highway operation) manufactured primarily for use in the transportation of not more than 10 individuals."

(3) Upon passage of the Gas Guzzler tax by the House of Representatives on August 5, 1977, the Joint Committee prepared for the Senate Finance Committee a document[9] explaining the Carter Administration's position on the House-passed bill. Significantly absent from the explanation was any objection to the Committee's definition of "automobile"--that the Carter Administration had decided to drop its proposal to apply the Gas Guzzler tax to vehicles with gross vehicle weight ratings between 6,000 and 10,000 pounds.

(4) On October 31, 1977, the Senate adopted its own energy bill[10] from which a Gas Guzzler tax was absent. The

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[9] Such document was issued on September 16, 1977, set forth (at pages 16-20)

[10] Senate action occurred with respect to H.R. 5263, a House-passed bill originally dealing with an import tariff on bicycle parts.

Senate and House energy bills thereupon went to Conference, where the Senate Conferees agreed to the House-passed Gas Guzzler provisions. No further action on the Gas Guzzler tax was taken until November 9, 1978, when it was enacted as Section 201 of the Energy Tax Act of 1978.

B. Technical Corrections Act of 1985

In its final form, the Gas Guzzler tax definition of "automobile" included all vehicles traditionally considered automobiles, with the significant exception of most Rolls-Royce model vehicles. Section 112(e)(1)(B) of the Technical Corrections Act of 1985 would repeal the de facto exclusion from the Gas Guzzler tax given to such vehicles. While Congress may not have intended to exclude any Rolls-Royce vehicles when it adopted the Gas Guzzler tax, it did not make that intention clear in the statute or the legislative history. To the contrary, Congress gave taxpayers (specifically Motors) every reason to believe that it had intended to tax only passenger automobiles with gross vehicle weight ratings not in excess of 6,000 pounds. It specifically rejected a proposal to give the Secretary of Treasury power to tax certain vehicles--such as the Rolls-Royce model vehicles at issue herein--in excess of 6,000 pounds and did not attempt to revise the de facto exclusion given to such vehicles for eight years. The proposed amendment constitutes a substantive retroactive change in the law made without notice to the one taxpayer (i.e., Rolls-Royce) it adversely affects and, therefore, is inconsistent with traditional Congressional self-restraint with respect to substantive retroactive changes in the tax law.[11]

11/ See, e.g., the opposition to retrospective tax legislation expressed by the Senate Finance Committee in connection with a bill introduced in 1950 to revise the formula for the taxation of life insurance companies to increase revenues:

> Even if your committee were of the opinion that a tax levied now on 1947 and 1948 incomes would be upheld by the Supreme Court, it would still oppose retroactive taxation extending over such a long period of time. The imposition of a tax on 1947 and 1948 incomes at this late date would be inconsistent with fundamental public policy which requires that a taxpayer's obligation to his Government be made definite and certain at the time the tax is due. S. Rep. No. 2375, 81st Cong., p. 39, August 22, 1950.

(Footnote continued on next page)

C. Conclusion

Congress was purposeful when it limited the scope of the Gas Guzzler tax to automobiles with less than 6,000 pounds gross vehicle weight ratings and, by the same token, achieved precisely what it intended to achieve when it gave the Secretary of Transportation authority to include automobiles with gross vehicle weight ratings between 6,000 and 10,000 pounds in the definition of "passenger automobile" for purposes of the EPCA. Congress specifically rejected the original Carter Administration proposal to grant similar authority to the Secretary of Treasury for purposes of the Gas Guzzler tax. In so doing, it effectively excluded most Rolls-Royce vehicles from the tax. Whether or not such an exclusion was intentional is not the subject of this request. It is both harsh and extraordinarily unfair for Congress to attempt to correct a statute on an 8-year retroactive basis without any notice to taxpayers. For these reasons, the proposed amendment to the Gas Guzzler tax should be prospective only.

(Footnote continued from previous page)
But see Section 641(b)(3) of the Tax Reform Act of 1984, which provides, in essence, that interest on bonds issued pursuant to the Housing Act of 1937, 42 U.S.C. §1437i(b), is not exempt from Federal estate and gift taxes. Section 641(b)(3) was added during the House-Senate Conference on the 1984 Act after it had become apparent that numerous taxpayers were taking advantage of a "windfall" created by a U.S. District Court decision that such bonds are exempt from Federal estate tax. See, *Haffner* v. *U.S.*, 585 F. Supp. 354 (N.D. Ill. 1984), aff'd, _____ F. 2d _____ (7th Cir. 1985). Although there continues to be much debate over the fairness of making the provision retroactive to 1937, it is clear that Congress never purposefully exempted Section 11(b) bonds from Federal estate and gift tax when it adopted the Housing Act of 1937.

0547j

STATEMENT OF
SMALL BUSINESS COUNCIL OF
AMERICA, INC.

commenting on

PROPOSED TECHNICAL CORRECTIONS
to the
RETIREMENT EQUITY ACT OF 1984

TO BE ADDED TO THE RECORD OF THE HEARINGS ON H.R. 2110, TO MAKE TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984.

Morton A. Harris, Esquire
Louis H. Diamond, Esquire
Lawrence J. Eisenberg, Esquire

STATEMENT OF SMALL BUSINESS COUNCIL OF AMERICA, INC.

PROPOSED TECHNICAL CORRECTIONS TO THE RETIREMENT/EQUITY ACT OF 1984

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On behalf of the Small Business Council of America, Inc. we appreciate very much the opportunity to provide this statement for consideration by the House of Representatives Committee on Education and Labor, the Committee on Ways and Means, and the Senate Finance Committee, regarding the H.R. 2110, Proposed Technical Corrections to the Retirement Equity Act (the "Act").

I. Introduction

The Small Business Council of America, Inc. ("SBCA") is a non-profit corporation which represents the interests of over 2,000 small business organizations located in 49 states. Most of these businesses maintain employee benefit plans qualified under Section 401(a) of the Internal Revenue Code. Consequently, SBCA represents the interests of a great number of businesses (and therefore employees) across the country who have a significant stake in legislation which affects the operational nature of qualified plans.

The Retirement Equity Act of 1984 ("REA") is perhaps the most complex tax act affecting pension plans since the Employee Retirement Income Security Act of 1974 ("ERISA"); and, in addition, REA has created many unanswered questions regarding the operation and administration of qualified plans. To date the Internal Revenue Service has provided little guidance as to the application of the REA provisions.

While we appreciate efforts made by Congress to eliminate uncertainties which exist under the provisions of REA as enacted, nevertheless, we believe that the proposed Act does not address all of the problems brought on by REA, and even creates areas of additional concern. This Statement, however, will be limited to matters that are appropriate within the scope of the Act, and to the extent feasible, the Statement will propose solutions.

II. Survivor Annuity Requirements

A. Spousal Consent Requirements for Survivor Annuities

Act Section 2(b)(6) clarifies the spousal consent requirement necessary for an employee to waive a qualified joint and survivor annuity and a qualified preretirement survivor annuity. Under REA, the spouse's consent must acknowledge the "effect" of the election in order for the employee to waive either of the survivor annuities. Code Section 417(a)(2). The Act clarifies this provision to specifically require designation of the beneficiary to whom the entitlements are to be paid, which may not be changed without the spouse's consent. The Act also provides a "one-time" consent by the spouse which permits the employee to designate (or redesignate) beneficiaries at any time without the spouse's further consent.

1. Informed Consent Clarification

SBCA commends the clarification of the spousal consent requirement. REA as currently enacted is too vague as to what information must be provided in order to properly obtain a spouse's informed consent to waive the survivor annuities. This problem is exacerbated by a lack of guidance in the Code, regulations, or by the Internal Revenue Service. As a result of this uncertainty there is extreme exposure, especially to small businesses, of plan litigation due to a failure to provide "informed" consent to the spouse. Moreover, as it now stands, REA subjects attorneys, accountants, administrators, and other plan advisers to an unprecedented exposure to malpractice lawsuits should a spouse believe she was not adequately informed of her rights. The Act, by clarifying the scope of the consent to specifically require naming the beneficiary, is a step in the right direction towards clarifying what constitutes informed consent.

SBCA strongly recommends that additional guidance be provided as to what "effects" have to be described to suffice as the consent requirement. Given the above risks, notices and consents provided by plan administrators and attorneys have tended to err on the side of providing as much information as possible, even though this is very burdensome to administrators and participants alike. The complexities of the notices and consents have frustrated everyone. To illustrate, a conservative interpretation of REA would require that the spousal notice and consent provide a comparison of the actual benefits payable under the plan under the various options. (This requirement existed under the survivor annuity rules under Code Section 401(a)(11) prior to the enactment of REA). This can result in staggering actuarial costs, especially since the notice and consent would have to be provided each time the employee changes his beneficiary.

To eliminate uncertainty, minimize administrative costs, and decrease the risk of lawsuits, SBCA strongly urges that Congress mandate the Internal Revenue Service to provide "sample" written notices and consents which would satisfy the informational requirements necessary for proper spousal consent. We would also suggest that these notices not require that the actual amount of benefits payable under the distribution methods provided by the plan be stated. This will help minimize the actuarial costs of providing these notices. Alternatively, SBCA urges that Congress mandate the Treasury to provide, as soon as possible, "safe-harbor" regulations which spell out precisely what information is required in order to properly inform a spouse of his or her rights under REA. Either the sample consent or the safe harbor regulations would significantly benefit the consenting spouse, as well as decrease expenses and the exposure of small businesses to plan litigation. These improvements would well be worth the cost of amending forms and incurring additional legal costs, consequences which would almost certainly follow passage of this Act.

2. Option of "One-Time" Spousal Consent

SBCA also approves the "one-time" spousal consent as a means to simplifying the onerous consent requirements now pertaining to the waiver of survivor annuities. SBCA recognizes that some feel that this provision is an "undoing" of REA, in that the "one-time" spousal consent does not protect the spouse should financial circumstances change, or the relationship with the beneficiary is altered. (Information derived from speech by William M. Leiber, Pension Counsel to the Joint Committee on Taxation, at the American Law Institute - American Bar Association Conference, Washington, D.C., April 25,1985.) We believe, however, that this problem may be minimized by regulations or rulings promulgated by the Internal Revenue Service, and urge their immediate promulgation or issuance should this Act take effect. All things considered, SBCA is of the opinion that this technical correction strikes a balance between the rights of the spouse and the negative consequences to qualified plans of burdensome recordkeeping requirements. After all, if businesses decide to terminate plans rather than to suffer continual increases in recordkeeping and administrative requirements, the spouses will not be benefitted from these consent provisions at all.

3. Possible Conflict with State Law

It should be noted that SBCA is aware of potential conflict between REA and state law concerning criteria for "informed consent." Various States provide different rules as to what constitutes informed consent, which may be inconsistent with informed consent as finally determined under REA. SBCA recommends that this conflict be eliminated by amending the Act to specifically state that for purposes of the Code and ERISA, the informed consent state law requirements are preempted by provisions in the Code and ERISA, and any regulations or rulings pertaining thereto.

4. Right of Spouse to Consent At Any Time

SBCA also believes that clarification is needed as to when spousal consent may be given to an employee's waiver of survivor benefits. Code Section 417(a)(2) is silent on the matter. The Senate Finance Committee Report states that "this consent is to be given in writing at the time of the participant's election . . .". However, Code Section 417(e)(2) provides that the surviving spouse may consent to immediate distribution of the present value of a survivor annuity. Apparently, Code Section 417(e)(2) would permit a post-death spousal consent, contrary to the Senate Finance Committee Report language. Congress should take advantage of the Act to clarify exactly when the spouse's consent may be given; at the same time it should coordinate the Senate Finance Committee Report language and the statutory language of Code Section

417(e)(2). To this end, SBCA believes that there is no compelling reason why the spouse's consent should be limited to the time of the employee's election to waive the survivor annuity. For example, if the spouse is amply provided for by other means, by a designation to the spouse outright, or by a carefully designed trust for her benefit and the benefit of other members of her family, the spouse should be able to consent to such designation of beneficiary at any time, even after the participant's death. For these reasons, there should be no time limit on the spousal consent.

5. Clarify That Spousal Consent is Not the Transfer of a Property Interest

A related issue is whether the spouse's consent constitutes a transfer of property for gift and estate tax purposes. It appears to SBCA that REA has created a new property right in the spouse. The Code, however, is silent on this issue. Note that Act Section 2(f) provides that if a spousal waiver (to waive a qualified preretirement survivor annuity payable under the transitional rules) is made on or before the end of the plan year to which REA applies, then the spousal waiver is not to be treated as a transfer of property for purposes of federal gift taxes. That provision seems to confirm SBCA's belief that the spousal actions to waive benefits are not to be considered a transfer of property for gift tax purposes. But since Act Section 2(f) addresses only the transitional rules under REA, there remains open the question of whether an exemption from the gift tax rules applies to other spousal consents under REA. SBCA urges Congress to specifically state in this Act that a spousal consent does not result in the transfer of a property interest.

6. Conflict with Prenuptual Contracts

REA creates possible conflicts between federal law and prenuptial agreements, and such possible conflicts should be avoided by clarifying amendments in the Act. SBCA believes that it is inappropriate for federal law to preempt prenuptial agreements which are valid under state law. Therefore, SBCA urges Congress to specifically state in the Code and ERISA that where a binding prenuptial agreement exists between spouses which addresses the issue of beneficiary designations of pension entitlements, an employee may waive one or both survivor annuities consistent with that binding prenuptial agreement, without an accompanying spousal consent. To this end, Congress should also address the issue of whether a valid prenuptial agreement would, itself, constitute a valid waiver of the survivor annuities (and consent thereto), since the participant and his or her spouse would by definition not be married at the time of the agreement. Furthermore, the same priority should be given to any binding agreement between a plan participant and his spouse entered into during the pendency of an action for legal separation or divorce; otherwise, if such an agreement is entered into and the participant dies before the divorce is granted, there will be a conflict between the binding contract under state law and the provisions of Federal law.

B. Qualified Preretirement Survivor Annuity Clarification.

Act Section 2(b)(1) generally provides that where an employee separates from service prior to death, qualified preretirement survivor annuities ("QPSA") will take into account only service actually performed until the employee separated from service. Act Section 2(b)(1) is intended to clarify and limit the measure of benefits due to surviving spouses upon the death of the employee prior to receipt of plan entitlements.

SBCA applauds this clarification as a means of eliminating unearned benefits to participants and their spouses, as well as reducing the costs of funding survivor benefits under a qualified plan.

However, since qualified plans were required to provide a QPSA from the enactment date of REA, there exists the possibility that QPSAs were or may be paid in an amount in excess of the amount required, taking into account the clarification made by the Act. SBCA therefore urges that guidance be provided in the Act or elsewhere indicating the manner of recouping benefits paid in excess of that required from a QPSA, as amended by the Act. In this regard, SBCA also urges that guidance be provided as to how QPSAs should be determined during the period during which passage of the Act is pending.

C. Clarification of Notification For Employees Hired After Age 35

Act Section 2(b)(5) provides that employees who are older than age 35 when hired are to be provided their written explanation of QPSAs within a reasonable period after being hired.

SBCA recommends that the explanation be provided upon the employee's becoming vested in any portion of his entitlements derived from employer contributions under the plan. This would be consistent with Joint Committee of Taxation's recommendations and would better coordinate selection of the form of preretirement benefits with their availability to the employee under the plan. Joint Committee on Taxation, Description of H.R. 2110 Relating to Technical Changes to the Retirement Equity Act of 1984 (JCS-14-85), May 14, 1985, Section B.5. It would also make more relevant the receipt of the explanation by the employee. Receipt of the explanation prior to the employee's eligibility to receive a QPSA would likely not be given the requisite attention by the employee. Delay in receipt of the explanation until after the participant is vested in any portion of his plan entitlements (as may occur if the explanation is provided three years after the date of hire, as proposed by the Joint Tax Committee) may preclude a participant's opportunity to waive the QPSA when he is entitled to do so by law. Id.

In this regard, SBCA also recommends that Code Section 417 be amended to permit vested employees who have not yet attained age 35 to receive their explanation of QPSAs at the time they vest in any portion of their plan benefits, and permit them to waive that form of benefit if they so desire (with their spouse's consent) at that time. Not only would this eliminate an arbitrary distinction between who _must_ receive a QPSA and who _may_ receive a QPSA, but it would also permit plan administrators to develop a uniform procedure for distributing QPSA explanations to plan participants. This would be especially beneficial to small businesses who administer their own plans. Moreover, this amendment would obviate potential 5th Amendment due process issues arising as a result of the impairment of an age group's right to contract and, where contractual rights already exist, from the deprivation of property without due process of law.

D. _Clarification of Impact of Fully Funded Survivor Annuities on Waiver, Consent and Notice Requirements under Code Section 417_.

SBCA believes that it would be appropriate to amend the Act to specifically state that where a plan fully subsidizes one or both of the survivor annuities, only the notice requirements pertaining to the fully subsidized annuity(ies) are exempted. REA as currently enacted states that Code

Section 417(a) shall not apply to fully subsidized survivor annuities. Code Section 417(c)(4). This may be interpreted to mean that where the survivor annuities are fully funded the survivor annuity form of benefit may not be waived (nor consented to by the spouse), resulting in the mandatory provision of survivor annuities to married participants, in accordance with Code Section 401(a)(11)(A).

Clearly this was not the intent of Congress. The Senate Finance Committee Report pertaining to Act Sections 103 and 203 states that "a plan is not required to provide notice of the right to waive the [survivor annuities] if the plan fully subsidizes the costs of the benefit." (Emphasis added). Consequently, the Code and ERISA should be amended by way of the Act to reflect this intention. Not only would this conform the law to Congressional intent, it would eliminate a potential restriction on the forms of benefits that may be paid, despite the preference of the participant and his or her spouse to the contrary.

E. Clarification of Exclusion of Voluntary Contributions

Since the Act seeks to amend Code Section 401(a)(11), SBCA believes that this would be an appropriate time to clarify that Section to provide that the survivor annuity rules apply only to employer and mandatory employee contributions. Nondeductible after-tax employee contributions are generally considered a savings mechanism and therefore not part of a true retirement program. Therefore, SBCA believes that requiring survivor annuity provisions to apply to voluntary after-tax employee contributions would be inappropriate and that the Code and ERISA should be amended to so state.

III. Spousal Consent Requirements - Expansion to Plan Loans

A. Practical Effects of Act Section 2(b)(4) - Recommendation

Act Section 2(b)(4) provides that no portion of a participant's accrued benefit may be used as security for a loan unless the participant's spouse (if any) consents in writing to such use. The Act mandates that the above requirement be incorporated in the plan document. These provisions apply to loans made after April 18, 1985, or revised, renewed, extended, or renegotiated after that date.

SBCA recognizes that the amendment is consistent with the concept of protecting spousal rights under qualified plans. Thus, it necessarily would follow that loans secured by the vested benefit should themselves provide for a spousal consent.

Nevertheless, SBCA recommends the deletion of Act Section 2(b)(4) for the following reasons: (1) the requirement will add yet another layer of complexity and paperwork upon the administration of qualified plans; (2) the costs of operating the plan will again increase; (3) legal fees will increase to protect or defend the plan and its trustees against suits by spouses who, due to a lack of guidance in the Code and Regulations or from the Internal Revenue Service, may not have been provided sufficient information to give "informed" consent as to this use of Plan assets; (4) increased legal costs will arise if the plan has already been amended for REA and must be re-amended to provide for this consent requirement; and (5) employer-employee relations may deteriorate if the additional restriction on plan assets is percieved as a restriction on plan entitlements by the employees. Taken together, SBCA believes that these reasons outweigh the additional protection afforded to spouses as a result of this provision.

Requiring spousal consent for use of plan assets as loan security will add to the already overwhelming complexity and paperwork of administering qualified plans. This addition will be particularly onerous to small businesses, since they are less likely to have the financial resources, personnel or expertise to adequately handle the increased operational functions of qualified plans. While small businesses recognize the need to protect spousal rights under qualified plans, SBCA has already perceived increasing levels of frustration from small businesses as a result of the existing high level of complexity. Where small business owners once established qualified plans to provide their employees with additional benefits, there is an increasing sentiment that qualified plans are more trouble than they are worth. This sentiment can only be enhanced by a provision which requires additional administration and paperwork. It is one thing to provide rules that effectively ensure that participants and beneficiaries receive their retirement benefits. It is another matter entirely when, as a result of legislation requiring amendment upon amendment, businesses become so overburdened and disenchanted that they terminate their qualified plans, thereby eliminating retirement benefits completely.

The spousal consent for loans involving plan assets will also increase the costs of administering the plan. New consent forms and procedures will have to be created. This will require additional professional fees to be paid in order to provide guidance as to the necessary informed consent (to the extent this can be determined without guidance from the Code, Regulations, or the Internal Revenue Service). In addition, valuable personnel resources will have to be used to administer this use of plan assets and the obtaining of required consents. If the small business utilizes an outside administrator for the plan, the increased administration to provide the spousal consent will be reflected in higher administrative fees.

Small businesses will have to establish procedures to obtain the spousal consent, which should also involve explaining the consequence of a plan loan to the employee and his or her spouse. Besides taking up valuable time, it is doubtful that small businesses (or personnel assigned to the task) will be sophisticated enough to determine whether the spouse was properly informed, or whether the consent will be valid under law. This problem is exacerbated by the lack of guidance regarding spousal notices and informed consent under REA. As a result there will be increased exposure to litigation involving the qualified plan, its trustees and/or administrators, as well as exposure by plan advisers (such as attorneys, accountants, and administrators) to malpractice lawsuits. (Discussion of the necessity to clarify what is "informed consent" may be found at Section II.A, infra). This will increase legal fees to the small business in two ways. First, legal advice will be necessary to provide safeguards (to the extent possible) against such litigation. Second, should a lawsuit arise due to the spousal consent requirements, legal costs will be incurred to defend the action.

The Act also requires that the plan document provide for the spousal consent to participant plan loans. To the extent the plan must be amended to provide for this requirement, the cost of amending and restating the plan will increase.

SBCA also anticipates a decrease in employee morale as a result of this amendment. Small businesses maintaining plans which provide for the use of plan assets as security for loans generally emphasize this availability as a means of enhancing employer-employee relations. Requiring spousal consent may be viewed by employees, at a minimum, to be an impediment to a participant's access to this plan benefit. This may result in the perception by employees that the qualified plan is not the employee benefit it was represented to be, thereby damaging the employer-employee relationship.

As a result of increased costs, risks, and complexities attributable to requiring spousal consent for the use of plan assets, SBCA fears that small businesses will terminate the relevant provisions from their plans, or worse, terminate their plans in entirety. We recognize the desire by Congress to minimize threats to the spouse's receipt of his or her plan entitlements. However, SBCA believes that the negative consequences of Act Section 2(b)(4) to small businesses outweigh the increased protection of spousal benefits under qualified plans.

SBCA has also noted a problem relating to the effective date of Act Section 2(b)(4). It is likely that subsequent to April 18, 1985, some plans have permitted use of plan assets as loan security without the required spousal consent. This may have occurred due to a lack of publicity regarding the Act, especially to the general public. Moreover, there will be uncertainty as to all plan loans until the Act is enacted. Therefore SBCA urges that if Act Section 2(b)(4) is not deleted, it be amended to apply on or after date of enactment, and not before.

B. Suggested Clarifying Amendments

Should Congress determine that Act Section 2(b)(4) be retained, SBCA suggests that the following clarifying changes be effectuated:

1. Have Act Section 2(b)(4) made effective as of date of enactment. (See discussion above.)

2. Permit Act Section 2(b)(4) to be applied without requiring incorporation into the plan document.

3. Provide a "safe harbor" as to what would constitute informed consent to the spouse. (See discussion at II.A. infra.)

C. Remaining Technical Issues

In addition, we have noted the following technical issues that we believe should be resolved if Act Section 2(b)(4) is to be retained.

1. Determine whether increased plan expenses attributable to providing these spousal consents for the use of plan entitlement as security for a loan may be taken into account in an equitable manner by the plan, similar to expenses attributable to the provision of survivor annuities. (See Code Section 417(f)(4)).

2. Clarify what type of consent is necessary. SBCA suggests either cross referencing to Code Section 417(a)(2) (but taking into account the change to that Section proposed by the Act (See II.A., infra)), or providing a separate Code Section addressing the proper manner of spousal consent for loans.

IV. Transferee Plan Rules

Act Section 2(b)(2) amends Code Section 401(a)(11)(B)(iii) to provide that a defined contribution plan other than a money purchase pension plan is not a transferee plan (for purposes of determining whether a plan must provide survivor annuities and comply with Code Section 417) with respect to a participant if a transfer ~~from a plan~~ required to provide the survivor annuities occurs before January 1, 1985. SBCA believes that small businesses would more easily be able to administer their plans, and determine whether survivor annuities will have to be paid, if Act Section 2(b)(2) were amended to provide that a plan described under Code Section 401(a)(11)(B)(iii) is a transferee plan only with respect to transfers made on or after plan years beginning after January 1, 1985.

The reason for this amendment is that January 1, 1985, is an arbitrary date to any plan which is not operated on a calendar year basis. Since REA generally requires that the survivor annuity provisions apply as of the first plan year beginning on or after January 1, 1985, SBCA believes it is inconsistent to require that survivor annuities be provided on account of an event which occurred prior to this effective date. Moreover, this amendment would avoid legal and actuarial costs necessary to amend this plan to provide these survivor annuities where, except for this transfer, it is the intent of the employer not to provide this form of benefit.

Act Section 2(b)(2) also provides that a separate account must be maintained for transferred assets. The Joint Committee on Taxation in its explanation of this provision also states that if separate accounts for transferred assets are not maintained, then the survivor benefit requirements will apply to all benefits payable with respect to the employee under the plan.

SBCA understands that the purpose of this provision is to prevent having to pay a survivor annuity on transferred amounts even though such form of benefit as required for the other benefits under the transferee plan. However, the Joint Committee on Taxation language regarding the maintenance of separate accounts is very broad in its scope, conceivably requiring separate accounts to be maintained where both the transferred assets and the transferee plan do not require that survivor annuities be paid. Therefore, in order to minimize additional recordkeeping to the extent possible, SBCA recommends that guidance be provided specifically addressing where separate accounts do have to be maintained and where separate accounts are not required.

V. SEP Eligibility

Act Section 2(a)(4) amends the eligibility requirements of Simplified Employee Pensions (SEPs), in pertinent part, from attainment of age 25 to attainment of age 21. SBCA is in favor of consistent eligibility requirements for SEPs and qualified plans. In this regard, however, SBCA is concerned that delay in enactment of the Act may cause uncertainty as to whether employees from age 21 to age 24 should be covered in the SEP by the employer. This may cause employers to have to choose between covering more employees than it needs or wants to, or risking disqualification of the SEP for failure to cover the necessary employees under law.

SBCA believes this potential conflict could be avoided by enactment of this Act as soon as possible. This will provide the necessary certainty required for complying with SEP eligibility requirements. Moreover it will allow employers the time to fund the SEP to take into account all eligible employees. Alternatively, in the event that this Act cannot be enacted until a later date, SBCA recommends an amended effective date for SEP eligibility which reflects the delay. This will minimize eligibility coverage and funding problems that could conceivably apply to employers sponsoring SEPs.

VI. Lump Sum Treatment; Recapture of Taxes

Act Section 2(a)(2) provides that for lump sum purposes, determination of the balance to the credit of an employee shall not take into account an increase in vesting which could occur upon reemployment. However, that Section also provides that if lump sum treatment were elected by the employee, and the employee was reemployed by the employer, any increase in the vested portion of the employee's pre-break accrued benefit will cause a recapture of taxes which were avoided by use of favorable taxation methods available on lump sum distributions.

SBCA objects to the recapture of previously taxed distributions under the Act as currently proposed. This recapture amounts to a tax upon rehiring an employee, creating a significant disincentive for an employee to return to a former employer. As a result, it will be more difficult for a small business to rehire a former employee within the break in service period as amended by REA. Given the extreme demand for talented employees, any provisions in any law which discourages the employee from being able to freely consider all possible opportunities for advancement, including reemployment by a former employer, should not be enacted or should be eliminated. SBCA believes that the recapture tax is just such a provision and as such should not be enacted.

Assuming, arguendo, that the recapture tax is retained, SBCA urges that it be specifically made clear that any tax paid under Code Section 402(e) (the ten year forward averaging provisions) or the recapture tax, be applied to reduce taxes payable on the subsequent distribution from the retirement plan. In effect, a permanent "lookback rule" should be provided. To do anything less is to provide a double tax on the distribution of plan entitlements. Moreover, it is urged that a method be devised to index the tax paid to take into account the present value of paying taxes immediately rather than upon the ultimate distribution of plan entitlements.

SBCA also wishes to note that Code Section 402(f) appears to require that upon certain distributions of benefits, employees should receive notice as to the provisions of Act Section 2(a)(2). We urge that immediate guidance be provided by the Internal Revenue Service as to what constitutes proper notice of these provisions. For example, it should be determined whether mere notice of the existence of the recapture tax (and/or its illustration) is sufficient, or whether a computation of the actual potential recapture with respect to the employee in question is required.

To this end, SBCA recommends that Congress mandate the Treasury to provide by regulation a "safe harbor" of information which, if included in a notice, would satisfy Code Section 402(f). Furthermore, we remind the Committee that the Internal Revenue Service is required to furnish an officially approved notice which administrators may use to explain available rollover treatment or, if applicable, 10-year averaging and capital gains treatment. Senate Finance Committee Report on the Retirement Equity Act of 1984, Section 207. It is urged that this notice also provide officially approved language which addresses Act Section 2(a)(2).

June 10, 1985

STATEMENT OF THE STOCK COMPANY INFORMATION GROUP BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE CONCERNING THE PROPOSED TECHNICAL CORRECTIONS ACT OF 1985 (S. 814)

The Stock Company Information Group appreciates this opportunity to submit comments to the Committee on Finance respecting the insurance-related provisions of S. 814, the proposed Technical Corrections Act of 1985 (the "bill"). These provisions appear as Part B of Title I of the bill, sections 121-128. The bill was the subject of a hearing by the Committee on June 5, 1985.

The Stock Company Information Group consists of 25 investor-owned life insurance companies. Taking into account its members' affiliated companies, the Group encompasses a majority of the 50 largest life insurance companies in the United States. The Group was organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and the Government. A list of our member companies is appended.

We are pleased to convey the support of our Group for the provisions of Part B of Title I of the bill. While we are generally quite satisfied with the life insurance tax revisions enacted as Title II of the Tax Reform Act of 1984 (the "1984 Act"), we welcome the several clarifying and correcting changes that the bill would make. Before turning to the few additional changes that we would urge be included in the bill, we wish to note our particular concern with certain of the items that the bill already covers.

As you know, representatives of the Stock Company Information Group were privileged to work with members and staff of the Finance Committee, as well as with their counterparts in the House of Representatives and with officials of the Treasury Department, in the development of the life insurance tax provisions of the 1984 Act. One of the most significant decisions made by the Finance Committee, and ultimately by Congress, in writing those provisions was to preserve the rules of former section 815 of the Internal Revenue Code (the "Code") as they related to the balances in stock life insurance companies' policyholders surplus accounts at the close of 1983. Thus, under new section 815(f) of the Code, "the provisions of subsections (d), (e), (f), and (g) of section 815 . . . as in effect before the enactment of the Tax Reform Act of 1984" are made applicable "in respect of any policyholders surplus account for which there was a balance as of December 31, 1983."

Subsequent to that enactment, a question arose as to the treatment under section 815 of bona fide loans made by a stock life insurance company to an affiliated corporation. Such loans had never before been treated as distributions subject to the rules of section 815, and it therefore should have been clear that that treatment was to be continued under the rules of the 1984 Act, consistent with the foregoing decision of Congress. To confirm this and dispell all doubt, section 121(j) of the bill appropriately provides that an "indirect distribution" within the meaning of new section 815(a) of the Code "shall not include any bona fide loan with arms-length terms and conditions." The members of our Group strongly endorse this provision.

Another significant judgment made by Congress last year was that, for the taxable year 1984, mutual life insurance companies should pay 55 percent of the industry's total income tax burden (estimated to be approximately $3.1 billion). Of all the decisions that made up Title II of the 1984 Act, the implementation of this one was perhaps the most fraught with technical difficulty. The primary mechanism instituted to accomplish this goal was the disallowance of deductions for dividends and other items by means of the formula appearing in new section 809 of the Code. While a similar goal was accomplished by a similar route under prior law, the specific mechanics of the 1984 Act in this respect are new and untested. It is therefore totally appropriate, and not unexpected, for the bill to make the number of changes that it does in the rules of section 809 and related provisions.

For example, section 121(c) of the bill would preclude companies from receiving tax benefits by accelerating the accrual of policyholder dividends. It seems that the emphasis new section 809 places on a mutual company's "equity base" was encouraging certain companies, at little or no economic detriment to themselves, to change their business practices so as to cause policyholder dividends that would normally have been declared in subsequent taxable years of the companies (i.e., the dividends would have been declared as of the various policy anniversaries occurring in the subsequent years) to become creditable to the policyholders in earlier taxable years. In this fashion, these companies attempted to meet the technical requirements for accelerated accrual of such dividends and thereby, arguably, to remove those dividends from the equity base. We understand it was a mutual company (or companies) that called this situation to the attention of congressional staff out of a concern that, by employing such a device, other mutual companies would fail to pay their requisite shares of tax, producing a shortfall in tax revenues from the mutual segment of the industry. We commend the Committee and its staff for their efforts to secure fulfillment of the intent of Congress that the mutual segment pay 55 percent of the industry's projected tax revenues. We also commend that mutual company (or companies) for focusing in a forthright manner on the principal, if not the sole, purpose of section 809.

We urge Congress and the Treasury Department to remain watchful over the new and untried rules of section 809, in order that they may achieve their intended purpose. Absent an appropriately strong mechanism of this sort, the express intent of Congress (as previously agreed to by mutual companies) that mutual companies should pay 55 percent of the industry's tax burden will not be realized. If this occurs, the total tax collections will be diminished in the amount of the mutual segment's shortfall, and stock companies will be forced to labor under a tax-induced competitive disadvantage.

The bill also makes several changes in the recently enacted rules bearing on annuity contracts, including variable annuities. These are found, respectively, in section 126 of the bill (amending section 222 of the 1984 Act and section 72(q) and (s) of the Code) and section 121(l) of the bill (amending section 817(h) of the Code). We understand that the Committee of Annuity Insurers, with which our Group has members in common, will also be filing a statement with you commenting on these provisions. We wish to take this opportunity to state our agreement with those comments. We commend them to you for prompt and favorable action.

We now turn to the items -- three of them -- that we would have you add to the bill. As we will presently explain, we believe that the bill should be amended to: (1) include in the first sentence of section 805(a)(4)(C) of the Code, which defines the term "100 percent dividend," a reference to section 245(b) of the Code; (2) coordinate section 121(c) of the bill (mentioned above) with section 419(e) of the Code (which defines the term "welfare benefit fund") as it would be amended by section 151(a)(8) of the bill; and (3) clarify the intent of the "deemed exchange" rule of subsection (f)(7)(B) of section 7702 of the Code, which defines the term "life insurance contract."

(1) 100 Percent Dividends -- Section 805(a)(4)(C) of the Code

As revised by the 1984 Act, section 805(a)(4) of the Code permits a life insurance company, in determining its "life insurance company taxable income," to deduct inter-corporate dividends received as provided in sections 243, 244, and 245 of the Code. See section 805(a)(4)(A). In so doing, the 1984 Act provision introduces the concept that "100 percent dividends" -- those that are received from certain controlled subsidiaries in accordance with a special election -- are deductible by the life insurer without regard to "proration" between the company and its policyholders under the formula of section 812 of the Code. For this purpose, section 805(a)(4)(C) defines such dividends to include "any dividend if the percentage used for purposes of determining the deduction allowable under section 243 or 244 is 100 percent." Curiously, this definition fails to refer also to section 245(b) of the Code, which employs "100 percent" in determining the deduction it allows corporations for certain dividends they receive from wholly owned foreign subsidiaries (where all of the subsidiaries' gross income is effectively connected with the conduct of a U.S. trade or business).

We believe that the omission of the reference to section 245(b) was unintentional. Section 245 was, in fact, referred to in section 805(a)(4)(A), and there is no reason why it should not also be incorporated into the subparagraph (C) definition of 100 percent dividends. Since the intent of Congress in writing new section 805(a)(4) was to provide a proration-free treatment for 100 percent dividends received by life insurance companies, and since section 245(b) dividends are accorded treatment equivalent to 100 percent dividends under sections 243 and 244 when received by all other corporate taxpayers, the bill should amend the section 805(a)(4)(C) definition to include a reference to section 245(b). Accordingly, we suggest that the subparagraph (C) definition be revised by deleting the phrase "section 243 or 244" and by substituting "section 243, 244, or 245(b)" in its place.

(2) Policyholder Dividends and Welfare Benefit Funds -- Sections 121(c) and 151(a)(8) of the Bill

Section 121(c) of the bill would cause a life insurance company to lose (in effect) its "fresh start" adjustment for policyholder dividends granted by the 1984 Act to the extent that its deduction for policyholder dividends was "accelerated" by virtue of a change in business practices. This would be effected by adding a new section 808(f) to the Code, which would deny such a company a deduction for policyholder dividends in the amount by which the business practice change otherwise results in an increase in the deduction (limited to the amount of the fresh start adjustment). In our discussion above, we noted that the purpose of section 121(c) was to preclude the enhancement of deductions by accelerating dividends normally accrued at contract year-ends falling within a later taxable year of the insurer to dates coinciding with an earlier taxable year. We also endorsed its enactment.

As currently drafted, however, section 121(c) of the bill would possibly, and improperly, draw within its ambit a situation in which (in response to another rule involved in the bill) policyholder dividends were "accelerated" merely to fall within the taxable year of the insurer in which the contract anniversary to which the dividends relate occurred. Just such an advancement of the dividend date may be appropriate to conform with the practices of certain group contract policyholders (typically employers) who, in order to avoid classification of their contracts as "welfare benefit funds" under new section 419(e) of the Code (added by the 1984 Act) as it would be amended by section 151(a)(8) of the bill, must include in income in the taxable year in which their contracts end any policyholder dividends with respect to the contract year just completed. To conform its accounting with these new practices brought about by the amendment proposed in section 151(a)(8), an insurer might properly seek to accelerate the accrual of dividends from a customary time, such as within several months after the close of the contract year, to an earlier time that coincides with the contract year-end.

To coordinate the effects of sections 121(c) and 151(a)(8) of the bill, we suggest that section 121(c) be amended to state that the provisions of new section 808(f) will not apply to policyholder dividends declared with respect to contract years that have expired in or with the taxable year of the insurance company. This would make it clear that group contract dividends declared with respect to policy periods which had completely expired by the end of the insurer's taxable year (typically the calendar year-end) would not be considered impermissibly "accelerated" within the meaning of section 121(c) of the bill and proposed section 808(f) of the Code.

(3) The "Deemed Exchange" Rule -- Section 7702(f)(7)(B) of the Code

When the bill was introduced, it was understood that several matters not then addressed in the bill, which were nonetheless possible subjects of correcting legislation, were left open for further work at the staff level. Included among these was the rule of subsection (f)(7)(B) of new section 7702 of the Code, which defines the term "life insurance contract" for all purposes of the Code. Section 7702(f)(7)(B) provides that any change in the terms of a life insurance contract which results in a reduction in the contract's future benefits is considered to give rise to an "exchange" of the contract for a new contract. It is therefore sometimes called the "deemed exchange" rule and, since it potentially carries major implications for the taxation of amounts distributed from a life insurance contract in connection with a partial surrender, it is also known as the "partial surrender" provision.

The members of the Stock Company Information Group strongly agree that the bill should contain an amendment to clarify the import of section 7702(f)(7)(B). The deemed exchange rule has been the subject of much misinformation within the life insurance industry, and we believe its clarification to be imperative. The problem here appears to stem from the fact that the statutory language, the related committee reports, and the explanation subsequently published by the staff of the Joint Committee on Taxation are not consonant with one another. Taxpayers -- both insurers and their policyholders -- find themselves wondering which official version to follow.

Since we understand that work on this matter has been proceeding at the staff level, we will not take up the Committee's time elaborating on the problem in this statement. Suffice it to say that it is of great importance to us that the definition of "life insurance contract" enacted by the 1984 Act succeed in its endeavor to distinguish between life insurance contracts and financial instruments used primarily for investment (particularly short-term investment) purposes. The rules of section 7702(f)(7) play a vital role in this endeavor. The members of our Group worked for the enactment of the provisions of section 7702, and we are anxious to participate with staff in the framing of a clarifying amendment for subsection (f)(7)(B) and then to support its enactment as part of S. 814.

Conclusion

In sum, with the few points noted above, we are pleased to affirm our support for the provisions of Part B of Title I of the bill. We offer our assistance to the members and staff of the Committee as efforts progress to refine and enact this bill.

June 10, 1985

STOCK COMPANY INFORMATION GROUP

- AETNA LIFE INSURANCE COMPANY COMPANY
- ALLSTATE LIFE INSURANCE CO.
- AMERICAN GENERAL LIFE INSURANCE COMPANY
- BUSINESS MEN'S ASSURANCE COMPANY OF AMERICA
- CAPITAL HOLDING CORPORATION
- CNA INSURANCE
- CONNECTICUT GENERAL LIFE INSURANCE COMPANY (CIGNA)
- FEDERAL KEMPER LIFE ASSURANCE COMPANY
- FRANKLIN LIFE INSURANCE COMPANY
- HARTFORD LIFE INSURANCE COMPANY
- E.F. HUTTON LIFE INSURANCE COMPANY
- IDS LIFE INSURANCE COMPANY INSURANCE COMPANY
- INTEGON LIFE INSURANCE CORPORATION
- J.C. PENNEY LIFE INSURANCE
- JEFFERSON STANDARD LIFE INSURANCE COMPANY
- LIBERTY LIFE INSURANCE CO
- LIBERTY NATIONAL LIFE INSURANCE COMPANY
- LIFE INSURANCE COMPAY OF VIRGINIA
- LINCOLN NATIONAL LIFE INSURANCE COMPAY
- PAUL REVERE LIFE INSURANCE COMPANY
- PROVIDENT LIFE AND ACCIDENT INSURANCE CO.
- SOUTHWESTERN LIFE INSURANCE COMPANY
- TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY
- TRAVELERS INSURANCE COMPANY
- WASHINGTON NATIONAL

SULLIVAN & CROMWELL

June 12, 1985

Interest Derived by U.S. Controlled Foreign Corporations in the Active Conduct of a Banking, Financing or Similar Business

Section 954 of the Internal Revenue Code of 1954 (the "Code") provides for an exclusion from the current taxation of income under Subpart F for certain interest, dividends, and the excess of gains over losses on securities derived in the active conduct of a banking, financing, or similar business or by an insurance company. These exclusions have been in the Code since 1962 when Subpart F was enacted and reflect Congressional recognition that U.S controlled financial businesses must compete in the international capital markets and should not be handicapped by tax burdens their foreign controlled competitors are not subject to. Although interest is often thought of as "passive income" subject to the anti-tax haven rules of Subpart F, interest derived by a banking, financing, or similar business or by an insurance company is akin to that earned by a manufacturing company from sale of inventory produced by it and therefore should be excluded from Subpart F income.

Section 881(c)(4)(A) of the Code, as added by Section 127 of the Tax Reform Act of 1984 (the "1984 Act"), overrides certain of the Subpart F exclusions in the case of portfolio interest derived by a controlled foreign corporation, including the exclusion in Section 954(c) of the Code for income derived in the active conduct of a banking, financing, or similar business or by an insurance company. This discriminates against U.S. issuers of debt obligations in the Eurobond market, discriminates against

U.S. controlled broker-dealers in favor of foreign controlled broker-dealers, together with resourcing provisions of Section 904(g) of the Code results in double taxation of U.S. controlled broker-dealers, and substantially increases the accounting requirements of controlled foreign corporations without any apparent benefit to the U.S. Treasury Department. Each of these points is elaborated below:

1. Section 881(c)(4) of the Code discriminates against U.S. issuers.

Since the repeal of the 30% withholding tax on portfolio interest and the issuance by the Treasury in August 1984 of temporary regulations, U.S. issuers have issued Eurobonds directly rather than indirectly through the use of Netherlands Antilles finance subsidiaries. The interest on such obligations is free from withholding tax by reason of Sections 871 and 881, but U.S. controlled foreign corporations may not invest in such obligations without generating income that will be immediately taxed under Subpart F. Interest issued by a foreign obligor, however, is not subject to the withholding tax and also is not subject to the current inclusion in the U.S. shareholder's income under Subpart F because it does not constitute portfolio interest.* Thus a United States issuer, including the

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* This point would be clarified by the Technical Corrections Act of 1985 recently introduced in the House of Representatives and the Senate which would amend Section 881(c)(2) of the Code by striking the phrase "which is described" in the matter preceding subparagraph (A) and inserting in lieu thereof "which would be subject to tax under subsection (a) but for this subsection and which is described in." See Section 11(d) of H.R. 1800 and S. 814, 99th Cong. 1st Sess. at pp. 65-66 (March 28, 1985) and Staff of the Joint Committee on Taxation, "Description of the Technical Corrections Act of 1985 at pp. 32-33 (April 4, 1985).

United States Treasury Department itself, does not have as broad a market for its obligations as a foreign issuer. This is inconsistent with the policy expressed by Congress in the Tax Reform Act of 1976 when the definition of U.S. property was amended to exclude obligations of domestic corporations not related to the foreign corporation making the investment. See H.Rep. 94-658, 94th Cong., 1st Sess. at p. 216 (1975) and S.Rep. 94-938, 94th Cong., 2d Sess. at pp. 225-27 (1976).

2. The override of the Subpart F exclusions for active conduct of a trade or business discriminates against U.S. broker-dealers.

U.S. broker-dealers generally conduct their international operations through controlled foreign corporations. The use of controlled foreign corporations has facilitated their participation in the international capital markets in many jurisdictions throughout the world. The exclusions in Subpart F were originally enacted in recognition of the fact that interest income to a banking, financing or similar business or an insurance company is akin to the income derived by a manufacturing company on the sale of its inventory, and such active income should not be subject to Subpart F in order to preserve the competitive position of U.S. based businesses. See S. Rep. No. 1881, 87th Cong., 2d Sess. at p. 83 (1962), reproduced in 1962-3 C.B. 788. The provisions of Section 881(c)(4)(A) directly contravene this policy.

This problem is in fact exacerbated by certain provisions imposed by the Treasury Department with respect to the distribution of Eurobonds and targeted registered securities. Under the regulations issued to implement the bearer bond provisions of Section 163 of the Code, distribution of securities to non-U.S. persons is considerably facilitated if all members of the selling syndicate are foreign persons. Furthermore, under the conditions imposed under the Treasury Department's two targeted registered issues, ownership of the targeted registered securities must reside in the foreign institution for at least 45 days. See Section 8.2, 9.1, and 10.1 of Offering Circular, "Foreign Treasury Notes of February 15, 1990, Series H-1990 (Nov. 15, 1985). The interest which accrues on the inventory of a dealer in securities will thus generate interest which, without the Subpart F exclusion, will be foreign personal holding company income currently taxed in the United States.

3. Section 881(c)(4) of the Code creates double taxation.

The center of most Eurobond activity is London, England. The controlled foreign corporations active in this market have office space, personnel, and other facilities there to conduct their operations. The United Kingdom currently taxes the income derived by these controlled foreign corporations attributable to their United Kingdom business at the current rate of 41.25%. The amount subject to tax would include the interest which accrues on the inventory of obligations bearing portfolio interest.

Although the income derived by the controlled foreign corporation is subject to tax in the United Kingdom, the amount of the foreign tax credit for the United Kingdom income tax imposed would be limited because of the resourcing provisions of Section 904(g) of the Code, added by Section 121 of the 1984 Act. Article 23(3) of the U.S.-U.K. Income Tax Convention treats income or profits derived by a resident of the United States which is taxed by the United Kingdom as United Kingdom source income for purposes of the foreign tax credit. Article 23(1) provides, however, that the obligation of the United States to grant a credit is subject to the "limitations of the law of the United States (as it may be amended from time to time without changing the general principle thereof)." Because the controlled foreign corporations may not be residents of the United States and because Section 904(g) may override the resourcing provision of Article 23(3) in any event, the effective limit on the allowable foreign tax credit in the case of a U.S. shareholder only deriving Subpart F income through its foreign incorporated broker-dealer would be zero.

4. Section 881(c)(4) of the Code creates considerable accounting complexity without corresponding benefits to the Government.

In order to comply with Section 881(c)(4) of the Code, a controlled foreign corporation would have to establish the amount of portfolio interest derived by it. Since portfolio interest is limited to obligations issued by certain U.S. persons after July 18, 1984, a broker dealer would have to have some means of identifying the debt instruments issued after July 18, 1984 and the portfolio interest which accrued on such debt obligations during the period held by the controlled foreign corporation. In addition, because deductions allowed in computing taxable income must be taken into account in determining Subpart F income, an allocation must be made of expenses and other deductions of the controlled foreign corporation to the obligations bearing portfolio interest. *Cf*. Treas. Reg. § 1.954-1(c). The need to make such an allocation raises many complex and arbitrary accounting questions which heretofore it has not been necessary to make. For example, because the exclusions under Section 954(c)(3) of the Code remain available for the excess of gain over loss, would loss on a broker-dealer's inventory of portfolio interest obligations be allocated to the portfolio interest derived on such obligations or would it offset other foreign personal holding company income otherwise qualifying for the exclusion? Since gain on securities inventory positions remains eligible for the exclusion, how should interest expense incurred to carry portfolio interest obligations be apportioned? In the case of foreign currency denominated obligations bearing portfolio interest, is the portion of the gain or loss attributable to currency appreciation treated as an adjustment to portfolio interest? Compare Treas. Reg. § 1.952-2(b)(1)(v)(c) (exchange gain or loss allocated between subpart F income and non-subpart F income under any reasonable method) with Vol. II Treasury Department's Report to the President at pp. 371-372 (November 1984) and The President's Tax Proposals to the Congress For Fairness, Growth and Simplicity at pp. 409-422 (May 29, 1985). It is not clear that any of these complex accounting determinations will result in greater revenue to the Treasury Department.

* * * * *

For the foregoing reasons, we respectfully request that Congress include an amendment to the Code, in the form attached, which would make it clear that the exclusion for interest derived in the conduct of an active trade or business is available for all interest income, including portfolio interest.

Randall K.C. Kau
Sullivan & Cromwell
125 Broad Street
New York, NY 10004

and

1775 Pennsylvania Avenue, NW
Washington, DC 20006

1. Section 881(c)(4)(A) of the Internal Revenue Code of 1954 is amended by striking subparagraphs (iii) and (iv) and re-numbering subparagraph (v) as subparagraph (iii).

2. The amendment made by Paragraph 1 above shall apply to interest received after the date of enactment of the Tax Reform Act of 1984 with respect to obligations issued after such date, in taxable years ending after such date.

LAW OFFICES OF
TOBOLOWSKY, PRAGER & SCHLINGER
A PROFESSIONAL CORPORATION
1900 SOUTHLAND CENTER
400 NORTH OLIVE, LB 258
DALLAS, TEXAS 75201
(214) 742-9205

EDWIN TOBOLOWSKY
HENRY D. SCHLINGER
JEROME L. PRAGER
STANLEY C. SIMON
RONALD L. MCKINNEY
N. HENRY SIMPSON, III
ROBERT A. MILLER
PETER M. GROSS
EMILY G. TOBOLOWSKY
PATRICIA P. REESER
STUART A. LAUTIN

J. MANUEL HOPPENSTEIN
(1910-1983)

JACK L. STUART
OF COUNSEL

May 24, 1985

Betty Scott-Boom, Esq.
Room SD-215
Dirksen Senate Office Building
Washington, D.C. 20515

Re: Technical Corrections to
Retirement Equity Act of 1984
Our File No. 64400-21-007

Dear Ms. Scott-Boom:

Sec. 2(c)(1) would amend Code Sec. 402(a)(9) so that distributions to an alternate payee who is a spouse or former spouse would be taxed to the alternate payee, but distributions to any other alternate payee would be taxed to the participant. This is inappropriate in one situation.

Suppose that a participant is employed in a community property state and that his wife dies. Her community property interest in the plan passes by her will or by intestacy to someone other than the participant (usually the children). When the participant retires, the children sue for the interest they inherited from their mother -- and win. Under these circumstances, the amount the court awards to the alternate payee should be taxed, in my opinion, to the alternate payee -- not to the participant.

Alternatively, assume the same facts, except that the participant remarries, names his new wife as beneficiary, and dies before retiring. Again, the children sue for the community property interest they inherited from their mother -- and win. Whatever amount the court awards the children should be taxed to the children, not to the new wife or the employee's estate.

Sec. 2(c)(4)(v) would amend Code sec. 414(p) by adding paragraph (9). This would permit a plan to make a payment before termination of employment, despite the requirements of subsections (a) or (k), but only if the present value of the payment to the alternate payee is $3,500 or less. If the interest in the plan awarded to the divorced spouse is her only source of liquid funds, she may have to fast until the employee terminates employment.

Sec. 2(b)(2)(A)(ii) and (B)(ii) provide that the transferee plan rules only apply to the transferred assets, i.e., the rest of the plan is not "tainted" if "the plan separately accounts for assets and the income therefrom." I suggest that this language be changed so that there would be no "taint" if "the plan separately accounts for the amount transferred (adjusted for plan earnings of losses)." As presently written, the language could be construed as requiring separate investment of assets. The language also does not recognize that investments can both increase and decrease in value. Finally, the language does not recognize the distinction between assets, which are shown on the left side of the plan's balance sheet, and account balance, which are shown on the right side. In most plans, assets are not allocated to specific accounts.

I suggest that H. R. 2110 add a provision to the effect that subclause (II) of Code Sec. 401(a)(11)(B)(iii) and clause (ii) of ERISA Sec. 205(b)(1)(C) do not give a participant the right to elect the payment of benefits in the form of a life annuity when the plan does not otherwise provide for annuities. If you do not want to put this into the statute, please put something to the same effect in the committee report.

Code Sec. 417(a)(3)(A) and (5)(A) and ERISA Sec. 205(c)(3)(A) and (6)(A) should clarify what is the "annuity starting date" when a profit sharing plan does not provide for benefits to commence at a particular age (except as required by Code Sec. 401(a)(9) and (14) and the incidental benefit rule). I think the "annuity starting date" should be the date such a profit sharing plan buys and distributes the qualified survivor annuity; the plan should be required to give ninety days notice before buying the annuity; and the participant should be able to waive this payment anytime before the plan buys the annuity.

A profit sharing plan can not issue annuities. If the annuitant dies prematurely, there is no way to forfeit the unpaid amount. Similarly, if the annuitant outlives his life expectancy, there is no employer obligation to keep the plan sound. Thus, a profit sharing plan, which is subject to the joint and survivor and preretirement annuity requirements because it is a transferee after 1984 from a pension plan, must fulfill the requirement by buying an annuity from an insurance company and distributing it. Code Sec. 417(a)(1)(A) and ERISA Sec. 205(c)(1)(A) should allow such a plan to permit waiver (and revocation of waiver) of a qualified and joint survivor annuity and qualified preretirement annuity not only at any time during the applicable election period but also either before or after the applicable election period. For example, a participant with an account transferred from a pension plan should be able (if the plan permits) to waive at any time before the plan buys the annuity. Similarly, the surviving spouse should be able to waive payment in the form of qualified preretirement survivor annuity at any time before the plan buys the annuity.

Code Sec. 401(a)(13), Code Sec. 414(p), and ERISA Sec. 206(d) should make a distinction between court orders when the plan is adjoined as a party defendant and those where it is not a party to the litigation. Most divorce lawyers ask the court to award an interest in the qualified plan without naming the plan as a defendant; the only parties to the litigation are the spouses. In this case, if the order is not a qualified domestic relations order, the plan must refuse to obey it. Obeying the order would disqualify the plan. See Letter Ruling 8010051, December 12, 1979, in which the Service held that, where benefits were not in pay status, the "qualified and tax-exempt status of the plans under sections 401(a) and 501(a) of the Code will be adversely affected if Corporation M and the Plans respond to a court order requiring payment to or for the former wife of Mr. A . . . ."

On the other hand, sophisticated family lawyers name both the spouse and plan as defendants in the divorce action. In this case, the plan has an opportunity to persuade the court not to enter an order which is not a qualified domestic relations order. If for some reason, however, the court enters an order that is not a qualified domestic relations order, and if the plan is unsuccessful in getting the order reversed on appeal or otherwise, it will be bound thereby. If it does not pay when the order becomes final, execution will issue; and the sheriff will levy on the plan's assets. Disqualification is not appropriate in these circumstances.

ERISA Sec. 514(a) and (b)(7) properly preempt any order which is not a qualified domestic relations order. If, however, an unqualified order becomes final, the plan should not be disqualified because the sheriff levies on its assets, or because the plan recognizes the inevitable and pays the judgment. This should be true not only in the case of domestic relations orders but also in the case of any other court orders, such as commercial judgments. There are many courts, and they sometimes make mistakes; if this were not true, there would be no need for appellate courts. A court's mistake should not result in plan disqualification, if the plan has exhausted all its remedies.

Sincerely yours,

Stanley C. Simon

SCS:am

cc: John H. Rodgers
George W. Jensen
Paul L. Bureau
Margaret A. Fuller
Janice Gregory

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN
101 PARK AVENUE
A PARTNERSHIP CONSISTING OF INDIVIDUALS AND PROFESSIONAL CORPORATIONS
NEW YORK, N.Y. 10178

TELEPHONE 212 557-8000
CABLE GORDLEX N.Y.
TELEX 147208
TELECOPIER 687-9116

THEODORE ALTMAN P.C.
DAVID M. BUTOWSKY P.C.
RONALD M. FEIMAN
ALLAN B. FREEDMAN
KENNETH B. GERSTEIN
JOEL M. GOLDBERG
C. MARTIN GOLDENBERG P.C.
STEPHEN A. HELMAN
DAVID N. HURWITZ
PAUL RICHARD KARAN
ELLIS L. REEMER
DOUGLAS B. RICH
BARRY D. SHALOV
BRUCE J. WEIN P.C.
MARC WEITZEN

STEVEN A. COPLOFF

ROBERT B. BLAUSTEIN
JORDAN L. BLEZNICK
JEFFREY C. BLOOM
JUNE M. BRETTLER
ARTHUR J. COTTRELL
STUART C. FISHMAN
NATHANIEL B. GORE
JEFFREY M. GUSSOFF
RICHARD M. HERVEY
LAWRENCE M. KAPLAN
MICHAEL J. KAPLAN
JONATHAN B. LAPIN
*
BRUNO DOV LEDER
MADONNA M. MALIN
JACO M. PLATT
JON B. RAND
VALERIE P. ROBERTS
WENDY L. RONES
KEITH L. SCHAITKIN
ROBERT J. SCHECHTER
STUART M. STRAUSS
LAURENCE B. TAUBER
STUART E. WAINBERG
ANDREW J. WEINER

E. LEONARD GORDON P.C.
PETER A. BAUER
COUNSEL

*MEMBER CAL. BAR ONLY

May 17, 1985

Ms. Betty Scott-Boom
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Request to Give Oral Testimony in Connection with Section 102(a)(9)(B) of the Technical Corrections Act of 1985 (H.R. 1800, S. 814)

Dear Ms. Scott-Boom:

We are writing on behalf of our client, Thomson McKinnon Leasing, Inc. ("TM") to request the opportunity to provide oral testimony in connection with the consideration by the Senate Finance Committee of Section 102(a)(9)(B) of the Technical Corrections Act of 1985, which would retroactively modify, to the detriment of TM and its clients, the "Wide-Body Exemption" which was contained in Section 31(g)(15)(D) of the Deficit Reduction Act of 1984.

Enclosed herewith for your consideration are copies of a letter and memorandum which were sent to the Honorable Thomas J. Downey on April 19, 1985, a copy of a letter that was sent to Ms. LaBrenda Stodghill, Legislative Attorney on the Professional Staff of the Joint Committee on Taxation, on May 8, 1985 and a copy of our letter sent to Joseph K. Dowley, Chief Counsel of the Committee on Ways and Means on May 8, 1985, pursuant to which we requested the opportunity to provide oral testimony in connection with the House Ways and Means Committee consideration of the Technical Corrections Act of 1985.

If you have any questions or desire further information, do not hesitate to contact us.

Very truly yours,

Bruce J. Wein

Enclosures.

bcc: Alan Arsht
Carolyn Blaydes
Ellis Reemer
Barry Shalov

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN
101 PARK AVENUE
A PARTNERSHIP CONSISTING OF INDIVIDUALS AND PROFESSIONAL CORPORATIONS
NEW YORK, N.Y. 10178

THEODORE ALTMAN, P.C.
DAVID M. BUTOWSKY, P.C.
DONALD M. FEIMAN
ALLAN G. FREEDMAN
KENNETH B. BERNSTEIN
JOEL M. GOLDBERG
E. MARTIN GOLDENBERG, P.C.
STEPHEN A. HELMAN

DAVID B. HURWITZ
PAUL RICHARD KARAN
ELLIS L. REEMER
DOUGLAS S. RICH
BARRY E. SHALOV
BRUCE J. WEIN, P.C.
MARC WEITZEN

STEVEN A. COPLOFF

ROBERT S. BLAUSTEIN
JORDAN L. BLEZNICK
JEFFREY E. BLOOM
JUNE M. BRETTLER
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JEFFREY M. GUSSOFF
RICHARD M. HERVEY
LAWRENCE M. KAPLAN
MICHAEL J. KAPLAN
JONATHAN B. LAPIN

BRUNO VON LERER
MADONNA M. MALIN
JACK B. PLATT
JON S. RANE
VALERIE P. ROBERTS
HENRY L. ROMES
KEITH L. SCHAITKIN
ROBERT J. SCHECHTER
STUART M. STRAUSS
LAURENCE B. TAUBER
STUART E. WAINBERG
ANDREW J. WEINER

*ADMITTED CA. BAR ONLY

TELEPHONE (212) [illegible]
CABLE [illegible] N.Y.
TELEX [illegible]
TELECOPIER [illegible]

E. LEONARD GORDON, P.C.
PETER A. BAUER
COUNSEL

May 8, 1985

Joseph K. Dowley, Esq.
Chief Counsel
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: Request to Give Oral Testimony in Connection With Section 102(a)(9)(B) of the Technical Corrections Act of 1985 (H.R. 1800, S. 814)

Dear Mr. Dowley:

We are writing on behalf of our client, Thomson McKinnon Leasing, Inc. ("TM") to request the opportunity to provide oral testimony in connection with the consideration by the House Ways and Means Committee of Section 102(a)(9)(B) of the Technical Corrections Act of 1985, which would retroactively modify, to the detriment of TM and its clients, the "Wide-Body Exemption" which was contained in Section 31(g)(15)(D) of the Deficit Reduction Act of 1984.

Enclosed herewith for your consideration are copies of a letter and memorandum which were sent to the Honorable Thomas J. Downey on April 19, 1985 and a copy of a letter that was sent to Ms. LaBrenda Stodghill, Legislation Attorney on the Professional Staff of the Joint Committee on Taxation, on May 8, 1985.

If you have any questions or desire further information, do not hesitate to contact us.

Very truly yours,

Bruce J. Wein

Enclosures.

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN

101 PARK AVENUE
A PARTNERSHIP CONSISTING OF INDIVIDUALS AND PROFESSIONAL CORPORATIONS
NEW YORK, N.Y. 10178

THEODORE ALTMAN, P.C.
DAVID M. BUTOWSKY, P.C.
RONALD M. FEIMAN
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KENNETH B. GERSTEIN
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C. MARTIN GOLDENBERG, P.C.
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KEITH L. SCHAITKIN
ROBERT J. SCHECHTER
STUART M. STRAUSS
LAURENCE S. TAUBER
STUART E. WAINBERG
ANDREA J. WEINER

*MEMBER CAL. BAR ONLY

TELEPHONE (212) 557-8000
CABLE GORDLEX N.Y.
TELEX 147208
TELECOPIER 687-5110

C. LEONARD GORDON, P.C.
PETER A. BAUER
COUNSEL

April 19, 1985

Hon. Thomas J. Downey
2232 Rayburn House Office Building
Washington, D.C. 20515

Re: Section 102(a)(9)(B) of the Technical Corrections Act of 1985 (H.R. 1800, S. 814)

Dear Mr. Downey:

We are writing on behalf of a client engaged in the investment banking business to express our objection to the above-referred to proposed legislative amendment (the "Proposed Amendment") that would make a substantive change in the law and apply it retroactively to the detriment of our client and its customers.

The crux of our objection is the definition of a "technical correction". A change in law that merely clarifies congressional intent known at the time of passage of a law can be accurately labeled a technical correction and is appropriately applied retroactively. However, a change in law that reflects a change in congressional intent surfacing after passage of a law is a substantive change of law that cannot be fairly applied retroactively to the detriment of a taxpayer. Under all notions of equity, a substantive change in law should be applied on a prospective basis only.

A memorandum containing a more detailed discussion of the law in this matter is enclosed herewith. However, set forth below is a summary of the facts and technical analysis which demonstrates that the Proposed Amendment is a substantive change in the law and, if enacted, would unfairly and retroactively reduce certain tax benefits that would otherwise be available to our client and its customers.

1. On June 27, 1984, Congress passed the Deficit Reduction Act of 1984 (the "Act") which included new rules (the "New Depreciation Rules") for depreciating property leased to a foreign person or entity. In general, the New Depreciation Rules provide for less generous depreciation allowances than prior law.

2. The Act provided numerous exemptions from the application of the New Depreciation Rules, including an exemption for certain wide-body commercial aircraft (the "Wide-Body Exemption"). The language of the Wide-Body Exemption clearly applies to any wide-body, four-engine commercial aircraft used by a foreign person or entity which was acquired by such foreign person or entity pursuant to a written binding contract entered into on or before November 1, 1983 so long as that aircraft is placed in service before January 1, 1986. The Committee Report accompanying the enactment of the Act did not contain any suggestion that the clear language of the Wide-Body Exemption did not properly reflect congressional intent.

3. On June 29, 1984, an investment group (the "Investor Group") sponsored by a subsidiary of Thomson McKinnon Leasing, Inc. purchased a Boeing 747 jet aircraft (the "Aircraft") from a subsidiary of Allied Corporation. The Aircraft was under lease to KLM - Royal Dutch Airline ("KLM") for a 12 year term. KLM originally purchased the Aircraft in 1971 and in December, 1983, KLM entered into a sale-leaseback with a subsidiary of Allied Corporation. A critical element of the acquisition by the Investor Group was the assumption that the Aircraft would be exempt from the New Depreciation Rules. The Aircraft clearly satisfied the requirements of the Wide-Body Exemption because KLM originally purchased the Aircraft in 1971 and has continuously used the Aircraft since that date.

4. Prior to March 28, 1985, members of the Investor Group received relevant information from our client to enable them to file their 1984 federal income tax returns on the basis that the New Depreciation Rules did not apply to the Aircraft. The Investor Group computed its depreciation deductions in accordance with prior law; *i.e.*, the Asset Depreciation Range System utilizing the straight-line method over 12 years and the modified half-year convention, resulting in an average annual depreciation deduction of approximately 8.33% of the Aircraft's purchase price.

5. On March 28, 1985, more than 9 months after passage of the Act, the Technical Corrections Act of 1985 was introduced in the House of Represenatives. If the Proposed Amendment contained therein is applied retroactively (as is currently proposed), the Wide-Body Exemption would be unavailable. As a result, the Investor Group would be required to use the New Depreciation Rules which would severely limit its depreciation deductions. The Investor Group would be required to compute its depreciation deductions utilizing the straight-line method over 15 years and the half-year convention, resulting in an average annual depreciation deduction of 6.67% of the Aircraft's purchase price. This would result in a reduction of approximately 20% in the depreciation deductions from the prior law rules.

6. The Technical Corrections Act generally provides that technical changes are to be applied retroactively; however, substantive changes are to be applied prospectively after March 28, 1985.

7. Although cast in the form of a technical correction, the Proposed Amendment is clearly a substantive change of law. Accordingly, the Proposed Amendment should not apply to an aircraft acquired by a taxpayer before March 28, 1985, the effective date for other substantive changes set forth in the Technical Corrections Act. To do otherwise, particularly in the situation where there has been substantial reliance can result not only in unfairness but also lead to an increased lack of credibility in our income tax system and create disorientation in the marketplace.

We would appreciate an opportunity to meet with you at your earliest convenience to discuss this important matter in further detail.

Very truly yours,

Bruce J. Wein

BJW/aw

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN

MEMORANDUM

The Deficit Reduction Act of 1984 (the "Act") included several provisions dealing with the depreciation methods available to U.S. taxpayers who lease property to foreign users. One of those provisions requires the taxpayer leasing property to a foreign person or entity to depreciate the property utilizing the straight-line method over 125% of the lease term and the half-year convention (the "New Depreciation Rules"). Under prior law the taxpayer would be entitled to depreciate the Aircraft over 12 years using the straight-line method and the modified half-year convention.

However, the Act contained many exemptions from the application of the New Depreciation Rules. One of the exemptions to the New Depreciation Rules, referred to herein as the "Wide-Body Exemption", is contained in Section 31(g)(15(D)* of the Act. That section provides, in substance, that the New Depreciation Rules are inapplicable with respect to wide-body four-engine commercial aircraft used by a foreign commercial airline, if such airline entered into a written binding contract to acquire such aircraft at any time on or before November 1, 1983 and if such aircraft is placed in service prior to January 1, 1986.

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* Section 31(g)(15)(D) of the Act reads as follows:

> Certain Aircraft. The amendments made by this section shall not apply with respect to any wide-body, four engine, commercial aircraft used by a foreign person or entity if --
>
> (i) on or before November 1, 1983, the foreign person or entity entered into a written binding contract to acquire such aircraft, and
>
> (ii) such aircraft is placed in service before January 1, 1986.

However, Section 102(a)(9)(B) of H.R. 1800* (the "Proposed Amendment")**, which was introduced in the House of Representatives on March 28, 1985, would retroactively modify the Wide-Body Exemption. Under the Proposed Amendment, the Wide-Body Exemption would apply only to new aircraft; that is, aircraft which are "originally placed in service" after May 23, 1983 and before January 1, 1986.

We believe that the Proposed Amendment to the Wide-Body Exemption, although cast in the form of a technical correction, constitutes a substantive change in the law. As such, the Proposed Amendment should not apply to aircraft placed in service by the taxpayer before March 28, 1985, the effective date for other substantive changes currently proposed.

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* The "Technical Corrections Act of 1985." In addition, an identical provision is contained in S. 814.

** The Proposed Amendment would revise clause (ii) of the Wide-Body Exception as follows:

> "(ii) such aircraft is originally placed in service by such foreign person or entity (or its successor in interest under the contract) after May 23, 1983, and before January 1, 1986."

If the Proposed Amendment is adopted and is applied retroactively, our client and presumably others will be severely prejudiced.

On June 29, 1984 (the "Purchase Date"), the date of purchase of the Aircraft, the clear language of the Act provided that the Aircraft would not be subject to the New Depreciation Rules and our client reasonably believed that depreciation deductions with respect to the Aircraft could be computed in accordance with prior law; *i.e.*, the Asset Depreciation Range System utilizing the straight-line method over 12 years and the modified half-year convention. If the Proposed Revision is *applied retroactively*, the Aircraft will be subject to the New Depreciation Rules and our client will be required to compute its depreciation deductions utilizing the straight-line method over 15 years and the half-year convention, resulting in an average annual reduction in depreciation deductions of approximately 20%.

Not only does the language of the Wide-Body Exemption clearly apply to the Aircraft, but there is absolutely nothing in the Committee Reports accompanying the enactment of the Act which would indicate that the Wide-Body Exemption was to be limited to *new* aircraft. The first and only indication that the Wide-Body Exemption might apply only to "new" aircraft is found in the General Explanation of the Revenue Provisions of the Act issued by the Joint Committee on Taxation in January 1985, more than six months after the Purchase Date.* Even this statement is far from clear since it doesn't limit the application to new aircraft. In any event, the statement should be given little weight since the Internal Revenue Service has announced that statements of the Joint Committee on Taxation are not considered "authority" for purposes of avoiding the "10% substantial understatement penalty" under Section 6661 of the Code.**

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* The General Explanation provides as follows:

> "Under a special rule for wide-body, four-engine, commercial aircraft, the Act does not apply to aircraft leased to a foreign person or entity if the foreign person or entity entered into a written binding contract to acquire the aircraft on or before November 1, 1983. This rule applies only to aircraft placed in service prior to January 1, 1986. This rule was intended to apply to new aircraft (i.e., aircraft placed in service after May 23, 1983)."

** Section 6661 of the Code provides for a "10% substantial understatement penalty" and final Treasury Regulations issued thereunder provide that "General Explanations" prepared by the staff of the Joint Committee on Taxation do not constitute "authority" for purposes of avoiding such penalty. Since the "General Explanations" do not constitute "authority" for purposes of avoiding the "10% substantial understatement penalty", it would be inequitable to treat pronouncements of the Joint Committee on Taxation as authority for other purposes including determining congressional intent in matters adverse to the taxpayer. As a result, taxpayers should not be charged with actual knowledge of the Proposed Amendment until March 28, 1985, the date on which the Technical Corrections Act was introduced in the House of Representatives. Fairness obviously dictates a prospective effective date of March 28, 1985 for the Proposed Amendment.

GORDON HURWITZ BUTOWSKY WEITZEN SHALOV & WEIN
101 PARK AVENUE
A PARTNERSHIP CONSISTING OF INDIVIDUALS AND PROFESSIONAL CORPORATIONS
NEW YORK, N.Y. 10178

[illegible]

May 8, 1985

Ms. LaBrenda Stodghill
Legislation Attorney
Joint Committee on Taxation
1015 Longworth House Office Bldg.
Washington, D. C. 20515

Re: Section 102(a)(9)(B) of the Technical Corrections Act of 1985 (H.R. 1800, S.814)

Dear Ms. Stodghill:

As a follow-up to our telephone conversation of Friday, April 26, 1985 concerning the letter sent to the Honorable Thomas J. Downey on behalf of our client Thomson McKinnon Leasing, Inc., we have given some additional thought to the concerns you expressed with respect to the effect on revenues of changing the retroactive effective date of Section 102(a)(9)(B) of the Technical Corrections Act of 1985 (the "Proposed Amendment"). The Proposed Amendmentwould modify the "Wide-Body Exemption" contained in Section 31(g)(15)(D) of the Deficit Reduction Act of 1984 (the "Act").

As we indicated to you in our telephone conversation, our client did not have any knowledge or reason to believe that the application of the Wide-Body Exemption was intended to be limited to new aircraft. Further, as we pointed out, the language of the exemption for binding contracts found in Section 31(g)(15)(C) (the "Binding Contract Exemption"), the section immediately prior to the Wide-Body Exemption, clearly states that property which has previously been used by a foreign person or entity could not qualify for the Binding Contract Exemption. By comparison, the Wide-Body

Exemption does not contain any such limiting language. Accordingly, it was logical for our client to assume that if the Wide-Body Exemption was not intended to apply in the situation where there had been previous use of the aircraft by the foreign user, then the Wide-Body Exemption would have included a restriction on previous use similar to the restriction contained in the Binding Contract Exemption. The General Explanation of the Revenue Provisions of the Act, dated December 31, 1984 and available in early January, 1985, contained the first indication that the statutory language of the Wide-Body Exemption did not reflect your intent.

One suggestion to achieve the desired objectives of fairness to our client and minimization of revenue loss is to exempt from the application of the Proposed Amendment any aircraft that was acquired and placed in service by a taxpayer after June 23, 1984, the date of filing of the Conference Report, and before December 31, 1984, the date of issuance of the General Explanation. As we also pointed out in our telephone conversation, we have no interest in having the exception to the Proposed Amendment apply to any aircraft other than our client's aircraft. Accordingly, if you have any suggestions as to a more restrictive effective date than the one we suggested, we would be happy to discuss it with you.

Thanking you for your consideration in this matter.

Very truly yours,

Bruce J. Wein

cc: George Yin
Tax Counsel
Senate Finance Committee
219 Dirksen Building
Washington, D. C. 20515

cc: Honorable Thomas J. Downey
c/o Carolyn Blaydes
2232 Rayburn House Office Building
Washington, D. C. 20515

TECHNICAL CORRECTIONS BILL OF 1985 (S. 814)
Hearing of June 5, 1985

STATEMENT OF JOE D. HEUSI, PRESIDENT, THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

The Variable Annuity Life Insurance Company ("Valic"), headquartered in Houston, Texas, is one of the country's largest issuers of annuity contracts purchased under section 403(b) of the Internal Revenue Code. We currently have more than 300,000 section 403(b) policyholders, the great majority of which are teachers and other employees of public school systems. Our contracts are specifically designed to satisfy the requirements of section 403(b), as well as to meet the needs of our policyholders.

Section 152(a)(3) of the Technical Corrections Bill of 1985 (S. 814) would establish new distribution requirements for annuity contracts purchased under section 403(b) by making the principles of Code section 401(a)(9) (relating to qualified plans) applicable to contributions made under section 403(b) contracts after the date of enactment of the technical corrections bill. We urge the Finance Committee to delete this provision from the bill for the following reasons:

1. Section 152(a)(3) would impose new substantive requirements on section 403(b) annuity contracts; these requirements are manifestly not in the nature of technical corrections to the Tax Reform Act of 1984.

2. Enactment of section 152(a)(3) is not necessary to carry out the intent of the 1984 Act or to further any important policy objective.

3. Enactment of section 152(a)(3) would place unwarranted administrative burdens on companies issuing section 403(b) contracts and cause unnecessary confusion among policyholders.

BACKGROUND

Pursuant to regulations and IRS rulings, it has long been established that the benefits payable under a section 403(b) contract must be for the primary benefit of the participant. In compliance with this requirement, our contracts (as well as those of other companies) require that benefits must commence no later than when the participant attains age 75, and benefits must be paid over a schedule which assures that more than 50 percent of the actuarial present value of benefits is paid to the participant.

The Tax Reform Act of 1984 enacted Code section 72(s), which prescribes post-death distribution requirements that must be set forth in all annuity contracts issued on or after January 19, 1985. Following the 1984 Act, we and other companies revised all of our section 403(b) contract forms to comply with section 72(s), and the revised contract forms were filed with and approved by insurance departments in 50 states and the District of Columbia.

The 1984 Act also changed the distribution rules applicable to qualified plans by amending Code section 401(a)(9); this change represented a liberalization of the qualified plan distribution rules that had been imposed by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). It is perfectly clear that the requirements set forth in section 401(a)(9) do not apply to section 403(b) contracts, and the legislative history of the 1984 Act provides no indication that such an extension of section 401(a)(9) was thought necessary or even contemplated.

REASONS FOR DELETION OF SECTION 152(a)(3)

1. Section 152(a)(3) is not a technical correction. Technical corrections legislation is intended to correct mistakes and clarify unnecessary ambiguities in recently-enacted legislation, not to impose new substantive rules. The integrity of the bill as a technical corrections measure requires that the principle of "mere technical corrections" be consistently followed.

By making the qualified plan distribution requirements applicable to section 403(b) contracts, section 152(a)(3) would plainly extend section 401(a)(9) beyond its current scope and, just as plainly, restrict the scope of section 72(s). Whereas the 1984 amendments to section 401(a)(9) were intended as a liberalization of TEFRA requirements, the technical correction would have the opposite effect for section 403(b) annuities. The substantive nature of section 152(a)(3) is confirmed by the fact that the same proposal has been made in the Treasury Department's proposals for fundamental tax reform.

We have been informed that staff had intended to make the section 401(a)(9) distribution rules applicable to section 403(b) contracts as part of the 1984 Act, and that the failure to do so was an oversight. Be that as it may, the change was never proposed or considered as part of the normal legislative process. The fact that there may have been an unstated intention to change the law in a particular manner does not convert a substantive change into a technical correction.

2. Section 152(a)(3) is not necessary. We recognize that there may be circumstances under which an amendment of truly substantive effect is appropriately made under a technical corrections bill, as for example, if Congress was unaware of the ramifications of a new provision at the time of enactment, or if a provision as enacted would undermine important policy objectives. Section 152(a)(3) falls in neither category and cannot otherwise be described as a necessary or important change.

The existing distribution rules applicable to section 403(b) contracts have approximately the same effect as the rules set forth in section 401(a)(9). The post-death rules of section 72(s) limit the deferral of benefits in almost exactly the same way as the post-death rules of section 401(a)(9). Further, the pre-death benefit schedules permitted under current law would generally be permitted under section 401(a)(9). The main difference between section 401(a)(9) and current rules applicable to section 403(b) contracts is that pre-death distributions would normally have to commence on April 1 of the year following the policyholder's attainment of age 70-1/2, whereas section 403(b) contracts now require benefits to commence at age 75. Cutting back from age 75 to April 1 of the year following attainment of age 70-1/2 cannot be regarded as such an important difference as to necessitate a change at this time.

The establishment of uniform distribution rules is not an end in itself. The current law rules applicable to section 403(b) contracts, though differing somewhat from the precise rules of section 401(a)(9), are perfectly adequate to carry out the policy objectives reflected in that provision. Moreover, the current rules have the advantage of being in place and widely understood. In any event, there is no abuse or loophole that must be eliminated under an expanded concept of technical corrections.

3. Section 152(a)(3) would impose unwarranted burdens on companies and policyholders. Although the changes required under section 152(a)(3) would not be great, contracts would unquestionably have to be changed. Having just completed this process to comply with the requirements of section 72(s), we and other companies would immediately have to amend our contracts a second time if section 152(a)(3) were enacted. Since the mandate of section 152(a)(3) is

not entirely clear,[1] a third set of contractual amendments might be needed upon the issuance of regulations. Moreover, if further changes were enacted as part of tax reform legislation, as has been proposed, still another set of contractual amendments would be required. It is impossible to implement new requirements in an orderly manner when such requirements are repeatedly changed in this manner.

More is involved in changing the terms of insurance contracts than simply changing the words on documents and having those changes approved by state regulators. Administrative and data processing systems must be established to assure that contractual terms are carried out, the sales force must be educated as to the nature and import of the changes in order to inform prospective policyholders, and, if necessary, existing policyholders must be notified. Such changes, especially those requiring the establishment of new systems, can entail very substantial expense. A change that may appear relatively small from a substantive standpoint can nonetheless pose significant administrative burdens.

Section 152(a)(3) would create especially onerous administrative burdens if enacted in its present form. As presently drafted, the bill would make the new distribution requirements applicable to contributions made after the date of enactment under existing contracts. This means that companies would have to amend existing contracts and then maintain two sets of accounts for each active policyholder, one applicable to contributions made before enactment of the bill, and the other applicable to contributions made after enactment of the bill. Such double bookkeeping would entail very substantial cost. In our case, for example, we would have to establish and track an additional 300,000 accounts for existing policyholders if section 152(a)(3) were made applicable to existing contracts. Moreover, we have no idea how the distribution requirements of current law and those proposed under section 152(a)(3) could both be applied to a single stream of benefits payable under a single contract. Even assuming that guidance were provided on how the different rules would interrelate, it would be virtually impossible to explain that interrelationship to policyholders in an intelligible manner.

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1. Under proposed section 403(b)(10) of the Code, "requirements similar to the requirements of section 401(a)(9)" must be met. Under section 401(a)(9), pre-death distributions must commence no later than April 1 of the year following the year in which the participant attains age 70-1/2 or retires, whichever is later. No explanation has been provided whether a section 403(b) participant who retires after age 70-1/2 would be permitted to delay the commencement of benefits under proposed section 403(b)(10) of the Code.

At the very least, therefore, it is essential that any change in the distribution rules be limited to newly-issued contracts. In order to provide an orderly transitional period, companies should have at least six months to revise their contract forms and establish new systems before new contracts are required to reflect such changes.

The central point remains, however, that there is no reason to change the law at this time: this is not a technical corrections issue; the rules of current law are in place and working effectively; and there is simply no cause to disrupt current practices to achieve a marginal change.

LAW OFFICES OF
BISHOP, LIBERMAN, COOK, PURCELL & REYNOLDS
1200 SEVENTEENTH STREET, N.W.
WASHINGTON, D.C. 20036
(202) 857-9800
TELEX 440574 INTLAW UI

IN NEW YORK
BISHOP, LIBERMAN & COOK
1155 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10036
(212) 704-0100
TELEX 222767

WRITER'S DIRECT DIAL
(202) 857-9816

June 7, 1985

Ms. Betty Scott-Boom
Senate Finance Committee
219 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510

Dear Ms. Scott-Boom:

On behalf of the Government of the Virgin Islands, please find enclosed five (5) copies of the Government's statement on S. 814, The Technical Corrections Act of 1985, for inclusion in the record.

Sincerely,

Peter N. Hiebert

Enclosures

cc: Dr. Richard Moore

STATEMENT
OF THE GOVERNMENT OF THE
U. S. VIRGIN ISLANDS

S. 814
The Technical Corrections Act of 1985

Committee on Finance
United States Senate
Washington, D.C.
June 5, 1985

Mr. Chairman and distinguished Members of the Senate Finance Committee, my name is Peter N. Hiebert. I am an attorney with the law firm of Bishop, Liberman, Cook, Purcell & Reynolds, which serves as Washington counsel to the Government of the U.S. Virgin Islands. I am pleased to have this opportunity to testify on behalf of the Government in support of a technical amendment to the tax exempt leasing provisions of the 1984 Tax Reform Act, which inadvertently eliminated an important incentive for capital investment in the Virgin Islands.

The tax exempt leasing provisions of the 1984 Act generally deny the investment tax credit and accelerated cost recovery system ("ACRS") deductions for property owned by a U.S. person and leased to or otherwise used by a "tax-exempt entity." A "tax-exempt entity" is generally defined under the 1984 Act to include government agencies, domestic tax exempt organizations and "any foreign person or entity." This definition has the unintended effect of denying the benefits of bona fide leasing transactions to Virgin Islands corporations which are considered foreign to the U.S.

The purpose of the 1984 tax exempt leasing provisions, as reflected in the legislative history, is, in part, to prevent foreign governments and other foreign persons who are not subject to U.S. income tax from taking unfair advantage of U.S. tax laws.

Virgin Islands corporations, however, are subject to U.S. income tax, but Congress has expressly provided, under Section 28(a) of the Revised Virgin Islands Organic Act, that V.I. corporations satisfy their U.S. income tax obligations by paying their applicable tax directly to the Virgin Islands.

The 1984 tax leasing amendments thus nullify the leasing benefits expressly extended to Virgin Islands corporations by Congress as part of the Foreign Investors Tax Act of 1966. (P.L. 89-809). According to the Senate Finance Committee Report to the 1966 Act, Congress acted to extend such benefits to the Virgin Islands because it believed that, "in view of the unique and close relationships that exist between the United States and its possessions, the economic development of these possessions should be stimulated by the same incentives that are offered to U.S. investment." (S. Rep. 89-1707).

The 1984 amendments may be viewed as treating foreign corporations more favorably than Virgin Islands corporations since an exception is made for foreign corporatins if more than 50 percent of the gross income derived by the foreign corporation from the use of such leased property is subject to direct U.S. tax or included in the gross income of a U.S. shareholder under the Subpart F rules. On the other hand, a Virgin Islands corporation that pays full U.S. corporate rates would continue to be denied such benefits because Congress has determined that the revenues raised by such taxes should go directly to the Virgin Islands Treasury.

The denial of such leasing benefits reduces the ability of the Virgin Islands to attract new capital investment and create new jobs. Correcting this technical oversight would have negligible revenue impact but would materially assist the Virgin Islands in its efforts to become economically self-sufficient. Moreover, the proposed amendment, a copy of which is attached to the end of my statement, is fully consistent with Congress' intent to curb abuses involving the investment tax credit and ACRS provisions and, most importantly, is fully consistent with long standing Congressional policy to encourage capital investment in the Virgin Islands.

TECHNICAL AMENDMENT TO S. 814

The Technical Corrections Act of 1985

IRC Section 168(j)(4)(C) is amended to read as follows:

"(C) FOREIGN PERSON OR ENTITY. For purposes of this paragraph, the term 'foreign person or entity' means

"(i) any foreign government, any international organization, or any agency or instrumentality of the foregoing, and

"(ii) any person who is not [(I)] a United States person [or(II) a corporation created or organized in, or under the laws of, a possession of the United States.]"

A Nevada—California energy generation development in White Pine County
Development Manager:
Los Angeles Department of Water and Power
Room 931, Post Office Box 111, Los Angeles, California 90051

Statement
before the
Senate Finance Committee
on the
Technical Corrections Act of 1985 (S. 814)
submitted by
Daniel W. Waters
Chairman
Management Committee
White Pine Power Project
on
June 5, 1985

Mr. Chairman, I would like to take the opportunity to raise an issue of primary concern to a number of California and Nevada public entities that stand to lose the benefits of a new coal-fired power plant if the Technical Corrections Act of 1985 is enacted as currently drafted. As presently proposed, the Technical Corrections Act could have a substantial adverse impact on the White Pine Power Project, which is now in its sixth year of planning and development.

The White Pine Power Project will be built in White Pine County, Nevada, a political subdivision of the State of Nevada with authority to finance projects for the generation and transmission of electricity under the Nevada County Economic Development Revenue Bond Law. As a political subdivision, White Pine County has issued, and proposes to issue, tax-exempt obligations to finance the White Pine Power Project.

In 1980, six California municipally owned utilities (the Department of Water and Power of The City of Los Angeles, and the California cities of Anaheim, Burbank, Glendale, Pasadena and Riverside), two Nevada investor-owned utilities (Nevada Power Company and Sierra Pacific Power Company), three Nevada political subdivisions (Boulder City, Nevada, Lincoln County Power District No. 1 and Overton Power District No. 5) and three Nevada rural electric cooperatives (Mt. Wheeler Power, Inc., Valley Electric Association, Inc. and Wells Rural Electric Company), entered into agreements to undertake the study and development of the White Pine Power Project. This proposed coal-fired 1,500 MW electric generating station would be located within White Pine County and built at a total capital cost of approximately $2.5 billion (1983 dollars). It is estimated that the Project would be in service in the early 1990's.

Most importantly to White Pine County, the White Pine Power Project will provide to it and the State of Nevada significant benefits in increased employment, economic activity and local tax revenues. Payroll during the construction of the generating facilities is estimated to exceed $57 million (1983 dollars) during the year of peak activity, and the operating payroll is estimated to exceed $13 million per year (1983 dollars). The Project will provide significant employment during both the construction and operation phases. Estimated local direct tax revenues from the generating facilities of the Project alone exceed $400 million (1983 dollars) over the life of the facilities.

Under the 1980 agreements, White Pine County is to own 81.333% of the Project, Nevada Power Company is to own 13.334% and Sierra Pacific Power Company is to own the remaining 5.333%. Consistent with the existing rules on industrial development bonds which exclude certain small participants from the calculation, the privately-owned utilities have an interest in White Pine County's share not exceeding 25%. The participation and financing arrangements for the Project were structured in 1980 to comply in all respects with the requirements under the Internal Revenue Code, to permit tax-exempt financing by White Pine County.

In 1980 and 1984, White Pine County issued tax-exempt notes in the aggregate amount of approximately $17 million to finance development and related costs of the White Pine Power Project on behalf of all the participants. Such notes are payable from, and secured by, payments to be made by such participants under project development agreements. As of March 31, 1985, in excess of $21,120,000 had been expended on development and related costs of the White Pine Power Project.

Upon successful completion of the study and development phase, the participants plan for White Pine County to issue tax-exempt long-term bonds to finance construction of the White Pine Power Project. The bonds will be payable from, and secured by, payments to be made by the participants under power sales contracts. In consideration of these payments, the participants will obtain entitlements to electric capacity and energy of the White Pine Power Project.

Under the Technical Corrections Act of 1985, however, it appears that White Pine County will be unable to issue tax-exempt bonds to finance the construction of the White Pine Power Project because the arrangements concerning the privately-owned participants' payment obligations may be treated, under the Technical Corrections Act, as making White Pine County's bonds "consumer loan bonds."

As a result of the Technical Corrections Act, the two investor-owned utilities in the Project would be precluded from participating under the present contractual arrangements and timetable. To impose new financing conditions and a new ownership/participation structure would be a potentially lethal blow to the Project. Further, if the Project were to be restructured, and survived, it could only do so after previously unforeseen and unnecessary expense and delay.

The 1984 Tax Act added Section 103(o) to the Code, providing that interest on obligations would not be tax-exempt if they are "consumer loan bonds." Section 103(o) of the Code provides that a bond is a taxable consumer loan bond if five percent (5%) or more of the proceeds are reasonably expected to be used, directly or indirectly, to make loans to non-exempt persons. Non-exempt persons include rural electric cooperatives and investor-owned utilities such as those involved in the White Pine Power Project. Thus, an obligation of White Pine County would be a taxable "consumer loan bond" if 5% or more of the proceeds are reasonably expected to be used directly or indirectly to make loans to non-exempt persons such as the privately-owned participants. As indicated, the participation shares of the privately-owned participants in the White Pine Power Project will exceed 5%.

There is no definition of the term "loan" in the 1984 Tax Act or any of the related legislative history. Although the law in this area is unclear, it is possible that the Internal Revenue Service would construe the proposed power sales contracts between White Pine County and the privately-owned participants as indirect loans for federal income tax purposes.

Under current law, including the 1984 Tax Act, the consumer loan bond provisions do not apply to the White Pine Power Project. A transitional rule contained in 1984 Tax Act Section 631(c)(3) provides that the amendments made by the 1984 Tax Act did not apply to obligations with respect to facilities "with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983." Because of the contractual arrangements previously entered into by the participants with respect to the White Pine Power Project, this transitional rule made the consumer loan bonds provisions inapplicable to the White Pine Power Project.

The problem arises because Section 169 of the Technical Corrections Act would revise the transitional rule set forth in Section 631(c)(3) of the 1984 Tax Act so that the consumer loan bonds provisions of Section 103(o) of the Code would apply to the financing of the White Pine Power Project. As a result, if the arrangements with the privately-owned participants were treated as loans for tax purposes, interest on bonds issued by White Pine County to finance the White Pine Power Project would not be tax-exempt.

Attached to the written text of my remarks is a suggested revision to the Technical Corrections Act which would (by specific reference to the borrowing made by White Pine County on November 12, 1980) continue the exclusion of obligations issued by White Pine County for the White Pine Power Project from the applicability of the consumer loan bonds provisions.

ANNEX A

The following would be added to Section 170 of The Technical Corrections Act of 1985:

SECTION 170. AMENDMENTS RELATED TO SECTION 632 OF THE ACT. At the end of section 632 of the Tax Reform Act of 1984, a new subsection shall be added to read as follows -

> "(h) CERTAIN OBLIGATIONS NOT TREATED AS PRIVATE LOAN BONDS. - Obligations (including refunding obligations) shall not be subject to Section 103(o) of the Internal Revenue Code of 1954 if -
>
> (A) such obligations were issued with respect to any facility, and
>
> (B) any obligation was issued on November 12, 1980 in the principal amount of $14,994,000 for the purpose of financing the development, study, or related costs incurred with respect to such facility or any facility related to such facility."